Dependent Care FSAs: Policy Proposals to Level the Playing Field for Low- to Moderate-Income Parents

Social Policy Institute White Paper | 19-02

Washington University in St. Louis
Social Policy Institute

Washington University in St. Louis

SOCIAL POLICY INSTITUTE

Dependent Care FSAs: Policy Proposals to Level the Playing Field for Low- to Moderate-Income Parents

Part 2 of a two-part series of white papers on dependent care flexible spending accounts from the Social Policy Institute's Workforce Financial Stability Initiative.

By Ellen Frank-Miller, Sophia Fox-Dichter, and Sloane Wolter

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.

Social Policy Institute White Paper | 19-02

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 are also grateful 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. Finally, we extend our sincere thanks to Human Resource professionals at several private universities for generously sharing their knowledge and insights.

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 (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 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 dependent care flexible spending accounts 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

Part 1 of this series explicates a range of design elements and administrative practices that create barriers to participation for LMI employees.

In particular, LMI parents are likely to have difficulty managing the DCFSA double-hit, the process that requires employees to both set pre-tax wages aside for child care expenses and then pay those expenses out-of-pocket before submitting documentation for reimbursement.

The first wave of the 2018 Household Financial Survey (HFS), distributed biannually to a random sample of LMI tax-filers using TurboTax Freedom Edition[1], included a module of questions about DCFSAs that was issued to all employed respondents who had dependents. Findings from the HFS indicate that, indeed, the double-hit puts LMI employees with young children (under age 5) who used DCFSAs at risk; these participants were more likely to overdraft their bank accounts than those who did not use DCFSAs ($\chi^2(1)= 4.76$, $p<0.05$).

Data from the HFS also indicate that LMI parents are unwilling to take the double-hit risk if they do not have a financial cushion to help them manage the reimbursement delay. 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 a DCFSA than those who "probably" or "certainly" could find $2,000 in case of an emergency ($\chi^2(3)= 10.09$, $p<0.05$).

Further, because LMI employees are less likely than their higher-paid counterparts to gain significant tax advantages through participation (National Women's Law Center [NWLC], 2016), they may judge the low level of reduced income tax available to them through DCFSAs to be too small to make participation worthwhile.

Finally, DCFSAs include a use-it-or-lose-it provision in which contributions that are not used for reimbursement by the end of a grace period following plan-year end are forfeited. Because LMI employees tend to have unstable child care arrangements (Henly et al., 2015), it may be more difficult for these workers to accurately estimate their annual child care costs. As a result, these employees may be less likely to believe the risk of forfeiture is worth the potential tax savings. This phenomenon is known as loss aversion (Kahneman & Tversky, 1979).

In this final part of a two-part series, we provide evidence of employer practices that address some limitations in DCFSA design and administration and offer policy proposals intended to:

- Provide meaningful incentives, such as refundable tax credits, for employers to offer substantive child care assistance to their employees;
- Address loss aversion that may prevent LMI employees from participating in DCFSAs;
- Reduce friction associated with DCFSA participation; and,
- Address interactions with certain tax credits (the Child and Dependent Care Tax Credit and the Earned Income Tax Credit) and Medicaid.

[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. Employer Practices that Address Limitations in DCFSA Design and Administration

In economics, the concept of friction refers to impediments to completing a transaction, such as the time and energy required to research a consumer purchase or fees associated with selling stocks (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 most severe point of friction for LMI parents considering DCFSA participation is the double-hit: having less money in one's paycheck due to pre-tax deductions to fund the DCFSA and then paying out-of-pocket child care expenses. The double-hit poses a cash flow challenge for LMI workers as they wait for reimbursement. During this reimbursement waiting period, LMI workers, who tend to have very little in short-term savings (Pew Charitable Trusts, 2015), must closely manage their spending and monitor bank accounts to avoid negative financial impacts, such as bank overdrafts and increased credit card debt.

Two uncommon, but beneficial, employer practices help ameliorate the double-hit: child care subsidies and direct payments to child care providers.

2.1 In the Spirit of the Economic Recovery Tax Act (ERTA) of 1981: Child Care Subsidies Provided by Employers through DCFSAs

Kelly (2003) explains that legislators involved in writing the child care-related provisions of ERTA included language that would exempt employer-provided child care benefits from being treated as taxable income to employees, giving them a status similar to health insurance benefits. She notes that legislators, "hoped the DCAP [Dependent Care Assistance Program] provision would encourage on-site child care centers and direct subsidies of workers' child care costs," and that they, "expected employers to spend some money on child care services."

At that time, as noted in Part 1 of this series, employee benefits consulting firms found a way to translate the language of ERTA into a new and unintended product that they could sell to employers: the DCFSA. During the course of our field scan, it became clear that offering employees subsidies for child care expenses in the spirit of ERTA was uncommon among U.S. employers.

However, we identified some employers that had leveraged the existing benefits infrastructure of their DCFSAs to provide the kind of financial assistance envisioned in ERTA: several private universities and one large financial institution.

In addition to information from publicly-available sources identified through Internet searches and reviews of academic literature, we interviewed four key informants at three universities to gain insight into motivations for offering this type of child care assistance and organizations' decision-making regarding processing these grants through DCFSAs. The universities were identified via snowball sampling following identification of one university that offered these programs through an Internet search. Each interviewee was asked to provide an introduction to colleagues whose organizations offered similar programs.

Table 1 below displays plan characteristics for five private universities and a large financial institution.

	University 1	University 2	University 3	University 4	University 5	Large Financial Institution
Maximum annual income to qualify for subsidy	< $150,000	< $130,000 for one child; limit increases based on number of children, up to a maximum of $160,000	< $175,000	≤ $130,000 adjusted gross income	≤ $120,000	< $100,000 adjusted gross income
Single or multiple plans (eligibility requirements vary widely between organizations)	Single	Multiple	Multiple	Multiple	Single	Single
If eligible, amount of award varies by income level	Yes	Yes	Yes	Yes	No	No
Awards vary by ages of children	Yes	No	Yes	No	No	Yes
Awards vary by number of children	Yes	Yes	Yes	No	No	Yes
Award limited by IRS DCFSA rules	Yes	Only for union employees' program	Yes	No, maximum award less than IRS limit	No, maximum award less than IRS limits	Yes
Awards administered through DCFSA	Yes	Yes for union employees only; non-union employees receive taxable reimbursements	Yes	Employees' choice; if a taxable payment is selected, employee may contribute the IRS maximum $5,000 to a DCFSA in addition to the award	Yes	Yes
Eligibility determination done by employer or vendor	Previously done by vendor; now done by employer	Employer	Employer	Employer	Unknown	Unknown
Reimbursements processed by employer or vendor	Vendor	Employer or union	Vendor	Vendor if deposited to DCFSA; otherwise, taxable check delivered to employee (no reimbursement process)	Vendor	Vendor
Tax return information required for eligibility determination	Yes	Yes	Yes	Yes	Yes	Yes

2.1.1 Most Employers' Awards Give Preference to LMI Workers

Four of these six employers structured their subsidies to favor their most financially-vulnerable workers. The other two employers provided a flat-rate award to eligible employees.

During interviews, key informants at Universities 1, 2, and 3 all emphasized the importance of providing assistance with child care expenses to as many employees as possible, but emphasized that lower-income employees were given priority during the award-making process. These universities also increased the amount of their awards based upon the number of children in the household. One respondent noted that they took into account the "higher burdens" facing families raising children with special needs.

2.1.2 Household Income is a Key Factor for Eligibility

Household income universally played a role in determining employees' eligibility for subsidies. However, maximum household income limits to receive awards varied widely and income was defined inconsistently.

Among these employers, maximum household income limits ranged from a low of $100,000 for the large financial institution to a high of $175,000 for University 3. However, some employers used adjusted gross income (AGI) from tax returns to measure household income while others used gross income or benefit-eligible income. In the case of University 2, the maximum household income limit was adjusted for the number of children in the household.

Maximum household income limits appeared idiosyncratic. University 3, which had the highest maximum household income limit, is located in a high-cost city. However, University 2 and University 5, which had lower maximum household income limits, are also located in high-cost cities. The large financial institution, which has locations nationwide, had the lowest income threshold for eligibility.

During interviews, universities indicated that they reviewed their plans' maximum household income limits from time to time and adjusted them when they seemed too low based on factors like cost of living in the community or the cost of child care.

2.1.3 Employers Give Varying Reasons for Offering Single or Multiple Plans

By creating multiple plans, universities afforded themselves the opportunity to gear plan designs to their strategic goals and balance benefits between unionized and non-unionized employee populations.

Recruitment of Top-Ranked Faculty

Universities compete fiercely for top-ranked faculty and offering child care subsidies appears to have become a norm among private universities. Thus, several of the universities offered multiple plans based upon employees' job statuses (faculty versus staff).

In these cases, interview respondents indicated that faculty plans were not run through DCFSAs so that awards would not be subject to Internal Revenue Service (IRS) limits. One participant noted, "When you look at [recruiting] faculty members, $5,000 is not enough to court someone [to join the faculty]."

At another university, a respondent explained that giving grants on a pre-tax basis to non-faculty members meant that the full award amount would be available to employees, in contrast to taxable awards for faculty.

At the same time, the interviewee acknowledged that grants awarded through DCFSAs involved, “so much regulation.”

Minimizing the Administrative Burden for LMI Families

One university indicated that providing child care subsidies outside of a DCFSA plan reduced the administrative burden on LMI families. Referring to the university’s non-union staff members, a respondent explained that paying awards through their DCFSA, “becomes more of a nightmare.” The respondent explained that the documentation requirements for reimbursement were onerous for employees. The interviewee further noted that the administrative requirements for reimbursement, as opposed to the up-front lump-sum amount currently paid to non-union employees at the beginning of the plan year, might not provide these employees with the access to resources for child care that the university wants to facilitate. The interviewee noted that the university adjusts award amounts up to account for employees’ tax liabilities, meaning, they calculate the expected taxes on the award and add that amount to the payment to the employee. In this way, the grant covers the taxes the employee would otherwise have to pay out of the grant awarded.

Another respondent observed that an advantage of having a separate plan for non-unionized, lower-wage workers was that the university was able to make awards that exceeded IRS limits on DCFSA contributions, further explaining, “Those [pre-tax] savings are viewed as less desirable when you’ve got the day-to-day of living to work through….If you’re living paycheck-to-paycheck, often [pre-tax reimbursements] are seen as more trouble than they’re worth.”

Collective Bargaining Agreements

Key informants noted that having partially-unionized workforces necessitated multiple plans. In these cases, unionized employees had access to child care subsidy awards through their collective bargaining agreements and these awards were generally administered through DCFSAs.

2.2 Dealing with the Double-Hit through Plan Administration Methods: Direct Payment to Providers

Some employers have attempted to ameliorate a significant limitation of DCFSAs: the double-hit that refers to the need for employees to set aside DCFSA contributions, pay for care out-of-pocket, submit documentation of these child care expenses to the plan administrator, and then wait for reimbursement. LMI employees rarely have the monthly cash flow or liquid savings to manage this reimbursement process.

These employers offer streamlined reimbursement processes that help address the double-hit by eliminating the out-of-pocket payment and reimbursement requirement. We identified two models of direct payment: scheduled direct payment to child care providers and use of a flexible spending account debit card that can also be used for health care flexible spending account contributions (HCFSAs).

2.2.1 Scheduled Direct Payments to Child Care Providers

Via an Internet search, we located publicly available information about a program offered by a large U.S. financial institution that offers employees the opportunity to set up automatic payments from their DCFSAs to their child care providers for eligible expenses. Per IRS regulations, these payments must be made after care has been provided. The website indicates that the program requires employees to submit appropriate documentation as proof of service.

This option eliminates the double-hit by enabling employees to contribute the cost of care to their DCFSAs but avoid the second outlay of funds that would be required to pay out-of-pocket for care. However, administrative burdens for employees remain beyond documentation requirements for payment.

The example below demonstrates the challenges of aligning DCFSA contribution timing with provider payments.

- Employee is paid biweekly, 26 paychecks per year
- Child care cost is $200/month, $2,400/year
- Employee contributes $2,400 to their DCFSA for the full cost of care
- $2,400/26 paychecks = $92/paycheck contributed to DCFSA
- $92 x 2 paychecks = $184 contributed to DCFSA most months; in months with 3 paychecks, $92 x 3 = $276
- If employee sets up direct payments to child care provider for $200 per month, the payment will be $16 short in some two-paycheck months; employee will need to pay provider out-of-pocket
- Once extra funds are deposited in the DCFSA during a three-paycheck month, the balance will cover the $200 per month direct payment in full
- When that excess runs out, an out-of-pocket payment would be needed again, depending upon when three-paycheck months fall
- Depending upon the timing of three-paycheck months, the employee could also be left with a DCFSA balance after plan-year end and would need to use up the balance before the end of the grace period

As a result, although direct payments to child care providers have the potential to be of value to employees who may not be able to manage cash flow issues caused by the double-hit, the approach does not eliminate the friction that may make DCFSA participation undesirable.

2.2.2 FSA Debit Card Payments to Child Care Providers

A similar payment option that ameliorates the double-hit is available from employers who allow their workers access to DCFSA reimbursement debit cards. While linked debit cards are commonly available for use in paying for medical expenses from HCFSAs, it appears that employers do not generally authorize use of these cards for dependent care expenses.

As with direct payments, IRS regulations require that payments be made after care has been provided. However, payments by DCFSA debit card do not require employees to submit documentation as proof of service as long as the provider uses a merchant category code that indicates that they are a child care provider. In the absence of an appropriate merchant category code, DCFSA debit cards may not be used.

The key limitation of DCFSA debit cards is that employees can only take advantage of this option if their child care providers accept payment by debit card. While child care centers may accept debit cards, home-based family child care providers and informal care providers, such as family members or friends, are unlikely to accept this form of payment.

Since LMI workers may be more likely to use informal care arrangements, which are generally less costly than center care, they may not be able to make use of DCFSA debit cards (Henly & Lyons, 2000; National Survey of Early Care and Education [NSECE] Project Team, 2015). However, LMI families who qualify for federal or state child care subsidies may be better able to afford center care. These families may be able to make use of DCFSA debit cards for the portion of the cost of care that is not covered by the federal or state subsidy.

3. Policy Proposals

DCFSAs present LMI parents with often unmanageable barriers to participation. These employees face a highly complex decision-making process when considering whether the modest reduction of income tax is worth the time, effort, and stress involved. Further, LMI parents face real risks by participating in DCFSAs as evidenced by findings from the Household Financial Survey (HFS) and statistics on forfeiture rates (Mercer Human Resource Consulting, 2013).

In short, DCFSAs were simply not designed with LMI parents in mind.

To make DCFSAs usable and valuable to LMI employees, public policy changes and employer practices must address the sources of friction and loss aversion inherent in DCFSA design. Specifically, the following issues must be addressed to improve DCFSA value and take-up by LMI families:

- The lack of meaningful incentives for employers to make contributions to DCFSAs and erosion of the value of the contribution limit;
- The use-it-or-lose-it provision and optional restrictions on qualifying events;
- The double-hit and reimbursement processing methods;
- The complexity families face when determining whether or not they will benefit from participation; and,
- Interactions with the Earned Income Tax Credit (EITC), the Child and Dependent Care Tax Credit (CDCTC), and Medicaid eligibility.

3.1 Incentivize Direct Child Care Grants and DCFSA Contributions for LMI Workers with *Refundable* Tax Credits

For Policymakers

The National Women's Law Center (2018) observes that the subject of tax credits for employers that provide child care benefits has recently re-emerged and further notes that such policies at both the state and federal level have failed to produce their intended results. Employer take-up rates remain extremely low decades after their initial introduction. The U.S. Child Poverty Action Group (2017) notes that lawmakers have previously proposed employer tax credits for DCFSA matching contributions. It seems likely that such a proposal will face poor take-up rates as well.

Businesses and their lobbyists have long been highly successful in using tax policy to improve financial results. So-called tax loopholes provide corporations with many opportunities to reduce their tax burdens (Gardner, McIntyre, & Phillips, 2017; U.S. Government Accountability Office, 2016). Howard (1999) points out that tax policy has long been a hidden repository of U.S. social welfare policies as well; providing employers with tax credits for child care benefits is one example.

Such policies have failed thus far. However, existing credits are non-refundable. Given the number of U.S. corporations that pay little or no federal taxes (Gardner et al., 2017), non-refundable tax credits may not be particularly appealing to a large number of employers.

Providing employers with refundable tax credits for direct child care subsidies and/or for DCFSA contributions that are focused specifically on LMI employees would create a more meaningful incentive for employers to provide such benefits.

3.2 Raise the Annual DCFSA Contribution Limit and Link Future Increases to the Consumer Price Index

For Policymakers

The current contribution limit for DCFSAs, $5,000 per year, has not kept pace with the rising cost of child care, which generally exceeds this amount for typical families with young children (Bivens, Garcia, Gould, Weiss, & Wilson, 2016). The contribution limit was established in 1984 and has never been raised. Raising the DCFSA contribution limit would benefit all employees. Increasing the limit could also benefit workers whose employers provide child care subsidies through their DCFSAs and are currently constrained by the $5,000 limit.

Additionally, the DCFSA contribution limit is not tied to inflation and, thus, the value of contributions is eroded year by year. Tying the limit to the Consumer Price Index could also benefit LMI workers.

3.3 Address Loss Aversion: Eliminate or Relax Use-It-Or-Lose-It and Modify Qualifying Event Rules for Changes in Child Care Providers

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, forfeiture of DCFSA contributions looms larger than pre-tax savings.

The following changes that address DCFSA forfeitures may make this benefit more valuable for LMI employees.

3.3.1 Eliminate or Relax the Use-It-Or-Lose-It Provision

Employees who are concerned about forfeiting a portion of their salaries if they have miscalculated their child care expenses may choose to forgo participation in DCFSAs, even in cases where they could reap some savings on child care expenses. Thus, eliminating, or at least relaxing, use-it-or-lose-it may increase participation by all employees, perhaps those whose budgets are tightest in particular.

For Policymakers: Eliminate use-it-or-lose-it or align provisions for all FSAs

There is precedent for relaxing the use-it-or-lose-it rule in flexible spending accounts (FSAs). Legislation proposed in 2011 would have allowed employers to distribute employees' unused HCFSA balances at plan-year end as taxable income (Mulvey, 2012). Further, IRS rules for HCFSAs changed in 2014 and employers may now allow their employees to carry a balance of $500 of unused HCFSA contributions into the new plan year (Dennis-Escoffier, 2014).

No such provision currently exists for DCFSAs, however. Implementing regulation changes that eliminate or soften the use-it-or-lose-it provision would benefit all DCFSA participants, including LMI employees.

For Employers: Alert employees at risk of forfeiture at plan-year end

LMI workers may be less hesitant to use DCFSAs if they believe their employers will help them avoid forfeiture by alerting those who end the year with outstanding balances. Prior to the 75-day deadline for submitting reimbursement claims for prior plan-year child care expenses, employers and their vendors could audit employees' DCFSA accounts and send alerts to employees who have not yet submitted reimbursements for any remaining balances. Alerts could include information about the 75-day deadline and instructions for submitting reimbursement claims.

3.3.2 Eliminate or Relax Qualifying Event Restrictions

Short of eliminating or relaxing use-it-or-lose-it, changing rules related to qualifying events may reduce loss aversion.

DCFSA contribution elections are made prior to the beginning of the plan year and remain in effect unless employees experience qualifying events. Qualifying events currently include changes in marital status, the birth or adoption of a child, the death of a dependent, or a change in work status. IRS regulations also permit employers to allow employees to change their contribution elections if they change child care providers during the plan year (USC 26 § 125(4)(f)). However, employers are not required to allow such changes.

As previously noted, unstable child care arrangements are not uncommon among LMI employees (Henly et al., 2015). Frequent changes in child care providers can impact employees' annual child care expenditures in unpredictable ways. For example, a relative or neighbor may become available to provide home-based care at lower cost than center-based care. Thus, requiring employers to include changes in child care providers in the definition of qualifying events may remove a barrier to DCFSA participation among these workers.

For Policymakers: Require that the definition of qualifying events include elective provider changes

Policymakers can acknowledge the reality of LMI workers' experiences with arranging child care by requiring employers to include elective changes of child care providers as qualifying events for DCFSA contribution election changes.

Under such a policy, employees could change their annual contribution elections to align with revised estimates of their child care expenses, reducing the risk of forfeiture if new child care arrangements are less expensive than those used in their original estimates.

For Employers: Allow contribution modifications for changes in child care providers and communicate with employees about qualifying events rules throughout the year

Since DCFSA plans are complex, employees who experience a qualifying event may be unaware of rules surrounding circumstances under which contribution election changes may be made. By proactively reminding employees of these rules, employers can help ensure that workers who qualify to adjust their contribution amounts can make changes to avoid forfeiture at plan-year end. Further, employers should include elective changes of child care providers as a qualifying event for DCFSA contribution election changes in their plans.

3.4 Reduce Friction to Increase Participation: Ameliorate the Double-Hit

The double-hit makes DCFSA participation among LMI employees, who are more likely than their higher-paid counterparts to live paycheck-to-paycheck, a significant burden. Both policymakers and employers can take steps to ameliorate the double-hit.

For Policymakers: Align availability of contribution provisions for all FSAs

As noted in Part 1 of this series, IRS regulations for health care flexible spending accounts require employers to give their workers access to the full amount of their annual elected contributions immediately at the start of the plan year. In contrast, DCFSA funds are not subject to this so-called uniform coverage rule; contributions are not available to employees for reimbursement until they have been deducted from their paychecks. If employees' submitted child care expenses exceed the balances in their DCFSAs at the time of submissions, they will not be reimbursed for excess expenses until further deductions have been taken from their paychecks.

Bringing DCFSA contribution availability provisions into line with the HCFSA uniform coverage rule would help ameliorate the double-hit.

For Policymakers and Employers: Create refundable tax credits for (and offer) "seed money" matching contributions

Avoiding the double-hit can also be achieved if employers deposit one-month seed contributions into their employees' DCFSAs at the beginning of each plan year. These deposits would match each employee's monthly contribution amount and would allow employees to begin reimbursements before they have an entire month of daycare expenses deducted from their paychecks. Policymakers could promote the provision of these contributions by creating a refundable tax credit for the employers that offer them.

Matching contributions of this type would come with a much smaller price tag than subsidies discussed earlier. For example, a one-month seed money matching contribution for a participant who elected to contribute the maximum of $5,000 per year to a DCFSA would amount to less than $417.

Employers could choose to provide seed money matching contributions to all DCFSA participants or could limit them to LMI employees for whom the double-hit poses the greatest burden.

For Employers: Streamline the reimbursement process through direct payment to providers

Implementing methods of making payments directly to child care providers, as opposed to requiring employees to pay out-of-pocket and submit expenses for reimbursement, would also help address the double-hit, albeit to a lesser extent than aligning DCFSA and HCFSA contribution availability provisions or providing seed money matching contributions.

Models for direct payment include facilitating automatic payments from employees' DCFSAs directly to providers and allowing employees to use FSA debit cards to pay providers who accept them.

3.5 Address Interactions with Tax Credits, Medicaid, and Federal/State Poverty Alleviation Programs

As explained in Part 1 of this series, in some circumstances DCFSA use can interact with the Earned Income Tax Credit (EITC) and Child and Dependent Care Tax Credit (CDCTC) that LMI employees may be able to claim. As explained below, in some cases, the interaction is beneficial and increases the amount of the credit for which LMI employees are eligible. In other cases, using a DCFSA is detrimental, lowering the amount of the credit employees may receive.

Similarly, in some cases, DCFSA use may help LMI employees qualify for Medicaid coverage, which can significantly benefit families. Further, regulations are currently unclear concerning whether DCFSA balances are counted as liquid assets in determining eligibility for poverty alleviation programs such as the Supplemental Nutrition Assistance Program (SNAP).

In all of these cases, determining how their personal circumstances will look at the end of the tax year is extremely complicated for LMI workers, which is a substantial source of friction that can limit DCFSA participation. Loss aversion also operates in these cases because the financial stakes of eligibility/ineligibility are high.

Addressing these issues may make DCFSA participation more appealing to LMI employees.

For Policymakers: Make the CDCTC a refundable tax credit and allow LMI employees to claim the full credit regardless of DCFSA contributions

As noted in Part 1 of this series, the CDCTC allows tax filers to reduce the taxes they owe by receiving a credit for child care expenses from the previous year. Currently, 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, then 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 CDCTC disproportionately benefits higher-income employees (Bell & Matsui, 2015). Policymakers can provide more generous child care benefits to LMI workers by making the CDCTC a refundable tax credit and by allowing families below a specified income level to claim the full CDCTC, regardless of their participation in a DCFSA.

For Policymakers: Following precedent, allow individuals the choice to include or exclude DCFSA contributions in EITC calculations

The key selling point for DCFSA contributions is that they are deducted from employees' paychecks before taxes. 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. Variation in the incentive for LMI workers to earn more money, thus raising their adjusted gross incomes (AGIs), is built into the EITC. At some points along the EITC curve, workers have a substantial incentive to increase their AGIs, making DCFSA participation, which lowers the amount of taxable income used to calculate AGI, undesirable. At other points, workers' refundable credit amounts decline as AGI increases. In these circumstances, DCFSA participation benefits LMI workers by decreasing the amount of taxable income used to calculate AGI, increasing the amount of the EITC credit they would receive.

Policymakers can address this dilemma by allowing individual taxpayers to choose whether or not to apply DCFSA contributions to their AGI calculations. Precedent exists for a policy change of this sort. For example, military service members are permitted to include or exclude combat pay from their AGIs for purposes of EITC calculations. Similarly, people who received emergency cash relief aid following Hurricane Katrina were allowed to use their prior year's income in their EITC calculations in 2005, according to their preference (Burman & Wheaton, 2005; Falk, 2014; Gould & Horowitz, 2011).

For Policymakers: Explicitly exempt DCFSA balances from asset limit tests for federal and state poverty alleviation programs

Poverty alleviation programs, such as Temporary Aid for Needy Families (TANF), the Supplemental Nutrition Assistance Program (SNAP), and the Low-Income Home Energy Assistance Program (LIHEAP) include asset limit tests for eligibility. LMI families are required to report any assets in their possession, such as savings accounts, when they apply to receive benefits.

Currently, policy is unclear as to whether balances in DCFSAs should be included for asset limit tests. Only a few states clearly specify that accounts of this type should not be included during the application process for certain programs.

Policymakers at both the federal and state levels can improve the situation by explicitly exempting DCFSA balances from asset tests. Since DCFSA balances accumulate and are reimbursed frequently, it is unlikely that including them in asset tests could tip the balance for LMI applicants such that they would be denied benefits. Nevertheless, providing clarity on this point could assuage loss aversion reactions and improve DCFSA participation rates.

For Policymakers: Create simple calculation tools for LMI employees and make them available to employers

Currently, LMI employees face a daunting task when attempting to calculate whether or not DCFSA participation will benefit them in light of the potential interactions identified above (CDCTC, EITC, Medicaid). Policymakers could create simple calculation tools, such as online calculators or worksheets that could be made available to LMI workers and given to employers for distribution during open enrollment.

The State of New York has created an online calculator of this sort, specific to its state laws, which could serve as a model (New York State, n.d.).

For Employers: Alert LMI employees to possible interactions during open enrollment

Employers can help employees make good decisions about DCFSA participation by alerting them to all of these potential interactions. Employers that have existing relationships with community-based organizations that support LMI families could refer employees to these resources for assistance in understanding the implications of DCFSA participation.

4. Conclusion

In this two-part series, we have examined dependent care flexible spending accounts from the perspective of low- to moderate-income parents and found them woefully inadequate to the task of helping defray the high cost of child care. How did we get here? Quite simply, the needs of LMI parents were not part of the equation when DCFSAs were invented by benefits consulting firms.

While DCFSAs offer employers and higher-paid employees some benefits, as currently designed they offer much less value to LMI parents (Bell & Matsui, 2015), yet another example of the “upside down” U.S. tax code that disproportionately benefits higher-income taxpayers (Levin, Greer, & Rademacher, 2014). 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 the working families who need it most.

We have offered a set of policy proposals intended to level the DCFSA playing field for LMI employees, including providing incentives for employer contributions, reducing friction, and addressing loss aversion and interactions with tax credits/Medicaid.

DCFSAs fall significantly short of helping LMI families afford child care expenses (Economic Policy Institute, n.d.; Laughlin, 2013). More substantive responses to address the unaffordability of child care for LMI families could include implementing refundable tax credits for employers that provide child care subsidies, making the CDCTC a refundable tax credit, and increasing state and federal spending on a range of programs such as Head Start, public school pre-K programs, and the Child and Dependent Care Block Grant program (Bivens, Garcia, Gould, Weiss, & Wilson, 2016). Further, policymakers could explore ways to combine the EITC with DCFSAs by allowing LMI employees to advance some of their credit into a DCFSA early in the tax year and making those dollars subject to direct payment to child care providers.

References

USC 26 § 125(4)(f)

Alden, P. M. (1983). A no-cost way to provide dependent care benefits. *Pension World.* 31- 32.

Bell, A., & Matsui, A. (2015). Tax provisions fail to fill the gaps in child care assistance for low-income families [National Women's Law Center Brief]. Retrieved on December 26, 2018 from https://nwlc.org/wp-content/uploads/2015/12/cc_rp_tax_provisions_cc_assistance.pdf.pdf

Bivens, J., Garcia, E., Gould, E., Weiss, E., & Wilson, V. (2016). It's time for an ambitious national investment in America's children: Investments in early childhood care and education would have enormous benefits for children, families, society, and the economy. Washington, DC: Economic Policy Institute.

Burman, L. E., & Wheaton, L. (2005). Who gets the child tax credit? [Tax Analysts Report]. Washington, DC: Urban Institute. Retrieved from http://webarchive.urban.org/publications/411232.html

Conant, C. A. (1908). The influence of friction in economics. *Science, 27*(681). 99-104.

Dennis-Escoffier, S. (2014, May/June). IRS modifies use-it-or-lose-it rule for FSAs. *The Journal of Corporate Accounting & Finance, 25*(4), 91-95. https://doi.org/10.1002/jcaf.21962

Economic Policy Institute (n.d.). The cost of child care in every state. Retrieved from https://www.epi.org/child-care-costs-in-the-united-states/

Falk, G. (2014).The Earned Income Tax Credit (EITC): An overview. Washington, DC: Congressional Research Service.

Gardner, M., McIntyre, R. S., & Phillips, R. (2017). The 35 percent corporate tax myth: Corporate tax avoidance by Fortune 500 companies, 2008 to 2015. Washington, DC: Institute on Taxation and Economic Policy.

Gould, B. R., & Horowitz, S. A. (2011). History of the combat zone tax exclusion (IDA Paper P-4766). Alexandria, VA: Institute for Defense Analysis.

Henly, J. R., & Lyons, S. (2000). The negotiation of child care and employment demands among low-income parents. *Journal of Social Issues, 56*(4). 683-706.

Henly, J. R., Sandstrom, H., Claessens, A., Pilarz, A. R., Gelatt, J., Kim, J., & Healy, O. (2015). Determinants of subsidy stability and child care continuity. Washington, DC: Urban Institute.

Howard, C. (1999). *The hidden welfare state: Tax expenditures and social policy in the United States.* Princeton, NJ: Princeton University Press. https://doi.org/10.1515/9781400822416

Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. *Econometrica, 47*, 263-291.

Kelly, E. L. (2003). The strange history of employer-sponsored child care: Interested actors, uncertainty, and the transformation of law in organizational fields. *American Journal of Sociology, 109*(3). 606-649.

Laughlin, L. (2013). Who's minding the kids? Child care arrangements: Spring 2011 [Current Population Reports, P70-135]. Washington, DC: U.S. Census Bureau. Retrieved from https://www.census.gov/prod/2013pubs/p70-135.pdf

Levin, E., Greer, J., & Rademacher, I. (2014). From upside-down to right-side up: Redeploying $540 billion in federal spending to help all families save, invest, and build wealth [CFED Report]. Washington, DC: The Corporation for Enterprise Development. Retrieved from https://prosperitynow.org/sites/default/files/resources/Upside_Down_to_Right-Side_Up_2014.pdf

Mercer Human Resource Consulting. (2013). National survey of employer-sponsored health plans. New York, NY: Author.

Mulvey, J. (2012). Health care flexible spending accounts. Washington, DC: Congressional Research Service.

National Survey of Early Care and Education [NSECE] Project Team. (2015). Prices charged in early care and education: Initial findings from the National Survey of Early Care and Education (NSECE) (OPRE Report #2015-45). Washington, DC: Office of Planning, Research and Evaluation, Administration for Children and Families, U.S. Department of Health and Human Services. Retrieved from https://www.acf.hhs.gov/sites/default/files/opre/es_price_of_care_toopre_041715_2.pdf

National Women's Law Center [NWLC]. (2016). Child care deductions favor high income families [Fact Sheet]. Retrieved from https://nwlc.org/wp-content/uploads/2016/08/Child-Care-Deductions-Favor-High-Income-Families.pdf

National Women's Law Center [NWLC]. (2018). Employer child care tax credits are ineffective at all levels [Fact Sheet]. Retrieved from https://nwlc-ciw49tixgw5lbab.stackpathdns.com/wp-content/uploads/2018/03/Employer-Child-Care-Tax-Credit.pdf

New York State (n.d.). DCAAcount tax savings calculator. Retrieved from http://www.flexspend.ny.gov/2019/dcaataxcalculator.asp

Pew Charitable Trusts. (2015). What resources do families have for financial emergencies? [Issue Brief]. Retrieved from http://www.pewtrusts.org/~/media/assets/2015/11/emergencysavingsreportnov2015.pdf

The U.S. Child Poverty Action Group. (2017). Family tax policy: A path forward to lifting children out of poverty. Retrieved from https://static1.squarespace.com/static/5783bb3f46c3c42c527e1a41/t/58fa430a37c5811f91bb5e6e/1492796173509/ChildPov_ReportWeb+April+2017.pdf

U.S. Government Accountability Office. (2016). Corporate income tax: Most large profitable U.S. corporations paid tax but effective tax rates differed slightly from the statutory rate [GAO-16-363]. Washington, DC: GAO. Retrieved from https://www.gao.gov/assets/680/675844.pdf

Acknowledgements

The Social Policy Institute at Washington University in St. Louis gratefully acknowledges the Annie E. Casey Foundation, which provided support for this white paper series. We would also like to acknowledge other funders who made this work possible: Intuit, Inc. and the Intuit Financial Freedom Foundation. We thank Jenna Hampton for her excellent research assistance. Lastly, we thank the thousands of tax payers who consented to participate in the research surveys and shared their personal financial information.

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.

About the Authors

Ellen Frank-Miller, PhD is a senior scientist at the Social Policy Institute's Workforce Financial Stability Initiative.

Sophia Fox-Dichter, MSW is a research project coordinator at the Social Policy Institute's Workforce Financial Stability Initiative.

Sloane Wolter, BA is a research assistant at the Social Policy Institute's Workforce Financial Stability Initiative.

Suggested Citation

Frank-Miller, E., Fox-Dichter, S., & Wolter, S. (2019). Dependent care FSAs: Policy proposals to level the playing field for low- to moderate-income parents (SPI White Paper No. 19-02). St. Louis, MO: Washington University, Social Policy Institute.