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Making Dependent Care FSAs Work for Low- to Moderate-Income Families: 5 Action Steps for Policymakers

Dependent Care Flexible Spending Accounts (DCFSAs) can help workers save money on child care expenses by using pre-tax dollars, but few employees actually use the accounts, particularly low- to moderate-income (LMI) employees, because:

- DCFSAs are difficult to understand; figuring out if they are possible to use and worth the trouble is a complex task for families.
- Families face a "double-hit" if they use the accounts – they have to set aside pre-tax dollars for child care expenses and then pay out-of-pocket before getting reimbursed.
- Using a DCFSA may require certainty about a year's worth of child care costs, with a possible penalty for over-estimating expenses (depending on each employers' plan rules).
- DCFSAs can interact with tax credits, Medicaid, and federal/state poverty alleviation programs.

Action steps for policymakers to make DCFSAs more usable and effective at reducing the child care cost burden:

1 Incentivize employers to make matching contributions and grants through refundable tax credits

- Lawmakers have previously proposed employer tax credits for DCFSA matching contributions.[1]
- Making these credits **refundable** is essential to incentivizing employers, such as those with no tax liability.[2]
- Contributions could help level the playing field for LMI workers who garner fewer tax deduction advantages than their higher-paid counterparts.[3]
- Some employers already contribute to employees' DCFSAs and see higher rates of account take-up. More employers could be enticed to provide these benefits if offered refundable tax credits.[4]

2 Raise the annual contribution limit and link future increases to the CPI

- The current contribution limit ($5,000) has not been raised since 1984.
- In 2018, the typical family with young children had child care costs well above the current $5,000 yearly DCFSA limit.[5]
- Tying the DCFSA limit to the Consumer Price Index (CPI) would prevent the value of contributions from eroding year by year.

3 Eliminate or relax use-it-or-lose-it and qualifying event provisions

- Allow employees to reclaim any funds left over at the end of the year as taxable income. Legislation that would have allowed reclamation for health care flexible spending accounts (HCFSAs) was proposed in 2011.[6]
- Allow employees to carry $500 of unused funds into the next plan year to mirror current rules for HCFSAs.
- Require changes in child care providers to count as qualifying events. Child care arrangements can change unpredictably, particularly for LMI workers.[7] Policymakers can acknowledge this reality and ensure that workers can change their DCFSA contribution amounts when their care providers change.

4 Ameliorate the double-hit

- Make the full amount of the elected contribution available at the start of the plan year by applying the HCFSA universal coverage rule to DCFSAs.
- Alternatively, create refundable tax credits for "seed money" matching contributions for employers that contribute at the beginning of the year to LMI employees' accounts.
- Seed money refers to a matching contribution equal to one month of LMI employees' elected contributions; with money already in their accounts at the beginning of the year, employees can avoid mismatched timing between when child care payments are due and when their accounts contain the proper funds for reimbursement.

5 Address interactions with tax credits, Medicaid, and federal/state poverty alleviation programs

- Make the Child and Dependent Care Tax Credit (CDCTC) refundable so that LMI employees who do not owe taxes can still gain child care assistance, and allow them to claim the full CDCTC regardless of DCFSA contributions. The CDCTC must be refundable in order for LMI employees to meaningfully benefit.[8]
- Allow employees to choose whether or not to include or exclude DCFSA contributions in Earned Income Tax Credit (EITC) calculations. This choice is already available for service members receiving combat pay.[9]
- Explicitly exempt DCFSA balances from asset limit tests for federal and state poverty alleviation programs.
- Create simple calculation tools for LMI employees and make them available to employers.[10]

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3. National Women's Law Center. (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
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8. Bell, A., & Matsui, A. (2015). Tax provisions fail to fill the gaps in child care assistance for low-income families. Washington, DC: National Women's Law Center.
9. Gould, B.R., & Horowitz, S.A. (2011). History of the combat zone tax exclusion (IDA Paper P-4766). Alexandria, VA: Institute for Defense Analysis.
10. New York State provides an online calculator to assist employees in determining what combination of DCFSA contributions and CDCTC utilization would be most beneficial for them. Retrieved from http://www.flexspend.ny.gov/2019/dcaataxcalculator.asp

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