Dependent Care Spending Accounts—

Do They Make Sense in 2003?

by Joe Lineberry and Dennis T. Blair

▶ **The perception that EGTRRA changes lessened the benefits of dependent care spending accounts (DCSAs) for employees, particularly the lower paid, is a myth.** *In fact, because EGTRRA allows salary reductions to dependent care spending accounts to increase employees' earned income tax credits, more employees will now benefit from DCSAs. In demonstrating how this is so, the authors provide general illustrations that employers will find useful for communicating the new tax credit-DCSA tradeoffs to employees.*◀

Many employers have sponsored a dependent care spending account (DCSA) for their employees as a way to save employee payroll taxes on their dependent care expenses. Employee participation in the DCSA has typically been low, around 1% to 3% of eligible employees. One of the reasons given for low participation is that some employees (typically those earning under $24,000 in family income) were better off with the federal dependent care tax credit than the DCSA salary reduction.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) tax law actually improved the federal dependent care tax credit for 2003 while slightly lowering the federal income tax rates. The combination of these two changes has caused some advisors to suggest that the DCSA will be even less useful for many employees in 2003 and later.

Employers have continued to offer the DCSA in spite of low employee participation, because the relatively high contribution per employee allows the employer to save enough FICA taxes to cover the administrative expenses of offering the DCSA. It also offers a family-friendly benefit at minimal cost to the employer. However, many employers' administrative burden has increased when their DCSA fails the 55% discrimination test. When they fail the test, they have to cut back contributions by highly paid participants. The EGTRRA changes will apparently further reduce the number of nonhighly paid employees in the DCSA, which would reduce employer FICA savings and make it even harder to pass the 55% DCSA discrimination test.

With these pending issues in such a minor benefits area, we are not surprised that some employers are thinking the DCSA is more trouble than it is worth. In this article, we intend to expose the myth that the EGTRRA changes hurt the DCSA. We will also offer some tables illustrating where the DCSA continues to make sense and offer a general illustration to use in communicating the new dependent care tax credit-DCSA tradeoff to your employees. Note that all of the tax illustrations and comparison in this article reflect the impact on federal taxes without factoring in the impact (if any) on state income taxes.

TABLE I

Pre-EGTRRA Dependent Care Decision Table
Tax Credit vs. DCSA

If adjusted gross income, after pretax salary reductions is	then use
More than $24,000	DCSA
$24,000 or less	Dependent care tax credit

BEFORE EGTRRA

Before the recent tax law changes under EGTRRA, the dependent care tax credit percentage dropped to 22% at $24,000 in family adjusted gross income. At that level of adjusted gross income, the dependent care tax credit percentage (22%) was less than the tax savings rate of 22.65% (15% from federal income tax rate plus 7.65% from the FICA rate) under the DCSA. As employees earned more, the dependent care tax credit percentage dropped to 20% and the tax savings rate increased to 35.65% (28% from federal income tax rate plus 7.65% from the FICA rate) or higher under the DCSA, thus making the DCSA the tax-preferred alternative for employees with adjusted gross income over $24,000.

Before EGTRRA, the tradeoff between the dependent care tax credit and the DCSA could generally be simplified as shown in Table I.

Obviously, this simplified illustration did not factor in the impact of state income taxes or the different maximum limits under the federal tax credit and the DCSA. But the illustration was generally true, and many employers relied on the $24,000 family income amount as a simple way to communicate to employees whether to consider contributing to the DCSA. For example, employees earning significantly below $24,000 (and, thus, having no taxable income) would have been better off using the DCSA to save FICA taxes.

THE EGTRRA MYTH

The EGTRRA tax law improved the federal dependent care tax credit as follows:

- The maximum credit was increased from 30% to 35%, and the earned income amount where the percentage credit begins to decrease changed from $10,000 in annual family income to $15,000.
- The maximum expenses eligible for the credit increased from $4,800 for two or more eligible children to $6,000 for two or more children.

Before this change, most taxpayers earning over $24,000 in family-earned income with more than one eligible dependent were limited to a federal tax credit of 22%. This well-publicized change in the dependent care tax credit allows an employee with $24,000 in family income to receive a credit of 30% of eligible expenses. Not until an employee earns over $39,000 does the dependent care credit percentage drop to 22%. Therefore, a larger number of employees would seem to be better off in 2003 using the federal dependent care tax credit than taking advantage of the DCSA.

However, EGTRRA also made a less publicized change in the calculation of taxable income related to the DCSA, which actually makes the DCSA more favorable for most employees eligible for the earned income tax credit (EITC). This change was effective in 2002. The EITC is a refundable credit for employees with family-earned income under around $30,000 who have dependent children. In general, the less the employee earns, the higher the EITC.

Until 2002, any employee salary reduction for the DCSA had no effect on the EITC, since the DCSA contributions could not be used to reduce earned income for purposes of the EITC. However, EGTRRA changed the law so employees can use their DCSA contributions to reduce their earned income for EITC purposes. Therefore, participants who make contributions to the DCSA through salary reductions actually increase their EITC. As long as the employee is eligible for the EITC, which includes most parents earning under $30,000 after the DCSA contribution, using a DCSA reduces their taxes by an extra 15.98% (an extra 21.06% if the employee has more than one dependent child). In most cases, this is enough to make the DCSA the tax-preferred alternative for employees in these pay ranges.

The 2003 dependent care tax credit-DCSA tradeoff schedule now resembles that shown in Table II. Table III shows the EITC phase-out range used in Table II. Note that all the employ-

TABLE II

EGTRRA 2003 Dependent Care Decision Table
Tax Credit vs. DCSA

If adjusted gross income, after pretax salary reductions, is	and earned income, after pretax salary reductions, is	then use
More than $39,000	Not applicable	DCSA
$39,000 or less	Above EITC phase-out range	Tax credit
	In EITC phase-out range	DCSA
	Below EITC phase-out range	Tax credit

TABLE III

EITC Phase-Out Range
Earned Income Includes Only Salary or Wages

		One Child	Two or More Children
End of range	Married filing jointly	$30,666	$34,692
	Others	29,666	33,692
Start of range	Married filing jointly	14,730	14,730
	Others	13,730	13,730

TABLE IV

	Federal Tax Credit Maximum Expense in 2002	Federal Tax Credit Maximum Expense in 2003	Dependent Care Spending Account in 2002 and 2003
One Dependent	$2,400	$3,000	$5,000
Two or More Dependents	$4,800	$6,000	$5,000

ees in the EITC phase-out range would be better off using the DCSA instead of the dependent care tax credit, even though their adjusted gross income is less than $39,000.

WHAT ABOUT THE INCREASE IN THE MAXIMUM ALLOWABLE EXPENSES FOR THE TAX CREDIT?

As noted above, the maximum allowable expense for the federal tax credit has changed under EGTRRA. The comparison of the maximum allowable expense is shown in Table IV.

Before EGTRRA increased the maximum expense limits for the federal tax credit, an employee with a large amount of dependent care expenses would generally be better off with the DCSA. This was especially true if the employee spent significantly more than $2,400 on the care for one dependent, because the employee earned a tax benefit for expenses over $2,400

TABLE V

EGTRRA 2003 Dependent Care Decision Table
Tax Credit vs. DCSA

If adjusted gross income, after pretax salary reductions, is	and earned income, after pretax salary reductions, is	and only one[1] dependent	then use
More than $39,000	Not applicable	Not applicable	DCSA
$39,000 or less	Above EITC phase-out range	Expenses are at least a "little more than $3,000"	DCSA
		Expenses are not at least a "little more than $3,000"	Tax credit
	In EITC phase-out range	Not applicable	DCSA
	Below EITC phase-out range	Not applicable	Tax credit

1. If an employee has two or more dependents and adjusted gross income of $39,000 or less but earned income above the EITC phase-out range, the employee should use the dependent care tax credit.

under the DCSA, which was not allowed under the federal tax credit.

If an employee requires care for only one dependent, the employee's decision process has not changed significantly. After EGTRRA, the employee will in most cases be better off with the DCSA if the employee is spending a little more than $3,000 per year on care for the one dependent. In Table V, we have revised our decision table to reflect the effect of the maximum allowable expense for the dependent care tax credit. Table VI defines what "a little more than $3,000" means.

Since EGTRRA has increased the maximum expense limit to $6,000 for more than one dependent, the federal tax credit now offers a higher maximum expense limit than the DCSA if the employee has more than one dependent requiring care. While an employee cannot use the DCSA and the federal tax credit for the same expense, IRS does allow an employee to use a DCSA and the federal tax credit for different expenses. Therefore, this EGTRRA change does not affect the decision process for the employee with two or more dependents. The employee can decide which vehicle (the DCSA or the federal tax credit) is better to use for the first $5,000 of expense. Then any expense over the $5,000 DCSA limit can be used for the federal tax credit.

Note that these expense limits for the federal tax credit and the DCSA apply to the total family unit. For example, the $5,000 DCSA maximum is the maximum DCSA salary reduction for both the husband and wife. If both of them reduce their pay by $3,500 in a taxable year (for a total DCSA salary reduction of $7,000 for one child), they would be taxed on $2,000 of the contribution to the DCSA. This $2,000 increase in taxable pay would occur when they file their federal tax return, so their maximum tax benefit would be limited to $5,000 per calendar year. The adjustment is made on Form 2441.

SUMMARY OF THE EMPLOYEE'S DECISION PROCESS FOR 2003

In summary, EGTRRA has not reduced the tax effectiveness of the DCSA. Because EGTRRA allows the DCSA salary reduction to increase the employee's EITC, more employees will now benefit from using the DCSA.

TABLE VI

Adjusted gross income, including wages, salary and other income (e.g., interest on bank accounts)		Little more than $3,000 means expenses for one dependent must be at least
Over	**But not over**	
$29,000	$31,000	$3,577
31,000	33,000	3,444
33,000	35,000	3,312
35,000	37,000	3,179
37,000	39,000	3,047

In general, employees should go through the following decision process for 2003:

- For employees who are not eligible for the EITC, the DCSA is better as long as their federal tax credit is under 22% (family earnings over $39,000).

  Note, however, that the advantage of the DCSA over the tax credit is not significant until the employee reaches the 27% federal income tax bracket (taxable income of at least $38,050 in 2003 for single employees who file as head of household). For married employees filing joint tax returns, their taxable income must be $47,450 or greater, based on 2003 tax brackets.
- As long as the employee is eligible for the EITC (approximate family earnings of $30,000-$34,000 after factoring in the DCSA salary reduction), the DCSA is the better vehicle for saving dependent care taxes.
- Employees who are spending more than $3,000 for the care of one dependent will typically be better off with the DCSA, due to the $3,000 limit on eligible expenses under the federal tax credit for one dependent.
- Finally, for those employees who have over $5,000 in dependent care expenses for more than one child, they should use the better vehicle (federal tax credit or DCSA) according to the above guidelines. Then they should use the federal tax credit for the next $1,000 to maximize their dependent care tax benefit.

With effective communication of these advantages, the EGTRRA changes should increase rather than decrease participation in the DCSA in 2003. In the appendix, we have attempted to simplify the content of this article with a one-page decision-making tool intended as an employee communication illustration. ◀

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APPENDIX

Dependent Care Spending Account or Tax Credit: Which Is Right for You?

Both the dependent care spending account and the tax credit are designed to save you money on your dependent care expenses by reducing your taxes. But which is the best option to choose?

Choose the dependent care spending account if

Your family-earned income for 2003 will be greater than $39,000.

Or

Your family-earned income for 2003 will be greater than $14,730 and either . . .

You'll have dependent care expenses for only one dependent and your expenses will be greater than $3,000.

Or

You'll be eligible for the earned income tax credit and you have a dependent child.

Definitions

Earned income: Your family income from working (yours and your spouse's, if married) minus any pretax deductions for benefits. Generally, this is the income shown on your W-2 form.

Eligibility for earned income tax credit: Several issues help determine eligibility for this tax credit. Typically, the main issue for eligibility is if your earned income is low enough to qualify.

- If you have one dependent child, your family income in 2003 from pay must be less than $29,666 in 2003 ($30,666, if married filing jointly) to qualify.
- If you have more than one dependent child, your family income from pay must be less than $33,692 in 2003 ($34,692, if married filing jointly) to qualify.

Pretax contributions you make for health care coverage, employee savings plans and flexible spending accounts help reduce your earned income. Making these pretax contributions may help you qualify for the earned income tax credit.

The dollar amounts shown above are based on federal law. You may want to consult your tax advisor for further assistance, especially for factoring in any impact on state income taxes.