

DEPARTMENT OF TAXATION

2018 Fiscal Impact Statement

1. **Patron** Karrie K. Delaney

3. **Committee** House Finance

4. **Title** Income Tax; Child Care Tax Credits

2. **Bill Number** HB 700

House of Origin:

X **Introduced**

 Substitute

 Engrossed

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would provide a series of partially refundable income tax credits for certain child care expenses paid by individuals and businesses, owning or operating a child care facility, and directors and staff at child care facilities. These credits would be limited to expenses or services performed with regard to a child care facility that primarily serves children under the age of six.

This bill would be effective for taxable years beginning on or after January 1, 2018, but before January 1, 2023.

6. **Budget amendment necessary:** Yes.

Item 339, Department of Social Services

7. **Fiscal Impact Estimates are:** Preliminary. (See Line 8.)

7a. **Expenditure Impact:**

<i>Fiscal Year</i>	<i>Dollars</i>	<i>Positions</i>	<i>Fund</i>
[2017-18]	\$0	0	GF
[2017-18]	\$0		FF
[2018-19]	\$247,262	7	GF
[2018-19]	\$170,500		FF
[2019-20]	\$556,951	7	GF
[2019-20]	\$0		FF
[2020-21]	\$556,951	7	GF
[2020-21]	\$0		FF
[2021-22]	\$556,951	7	GF
[2021-22]	\$0		FF
[2022-23]	\$556,951	7	GF
[2022-23]	\$0		FF
[2023-24]	\$556,951	7	GF
[2023-24]	\$0		FF

8. **Fiscal implications:**

Administrative Cost

The Department of Taxation ("the Department") has not assigned any administrative costs to this

bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. As stand-alone legislation, the Department considers implementation of this bill as “routine,” and does not require additional funding.

The Department will provide specific administrative costs on any legislation that is not “routine.” Additionally, the Department will review all state tax legislation likely to be enacted prior to the passage by each house. If the aggregate number of routine bills likely to pass either house is unusually large, it is possible that additional resources will be required. If so, the Department will identify the costs at that time.

The Department of Social Services (“DSS”) estimate their cost for the implementation of this bill at \$417,762 for Fiscal Year 2019 (\$247,262 General Fund and \$170,500 Federal Funds), and \$556,951 GF per year for Fiscal Years 2020 to 2024. They will need 7 positions beginning in Fiscal Year 2019.

Revenue Impact

The bill would have an unknown, but potentially significant, negative impact on General Fund revenue beginning in Fiscal Year 2019. The extent to which taxpayers would qualify for and claim each of the credits that would be provided pursuant to this bill is unknown.

Child Care Expenses Tax Credit

According to IRS Statistics of Income (SOI) data, the federal child care credit was claimed on 197,810 returns filed by Virginia residents in a total amount of \$112.8 million, after taking into account a reduction for the child and dependent care expenses deduction. SOI data indicates that 208,528 returns filed by Virginia residents claimed \$529.2 million worth of the child and dependent care expenses deduction. After applying the credit percentages based on federal adjusted gross income and the percentages based upon the type of child care facility, the Department estimates that the proposed Child Care Expenses Tax Credit would have an annual negative General Fund revenue impact of approximately \$20.64 million.

Child Care Provider Tax Credit

According to JLARC, there are 1,628 providers that receive the child care subsidy and serve children younger than age five. Of these providers, 391 participate in Virginia Quality, the state’s quality rating and improvement system. Based upon these providers, it is estimated that the proposed Child Care Provider Tax Credit would have an annual negative General Fund revenue impact of at least \$2.3 million. This estimate is likely understated, as it does not take into account the increased number of providers that would participate in Virginia Quality, nor does it take into account the additional children age 5 that are receiving the state child care subsidy.

Child Care Directors and Staff Tax Credit

There were 13,580 child care workers in centers in Virginia during 2017. If all of these workers were to attain the highest professional development level (Level 4), the proposed Child Care Directors and Staff Tax Credit is estimated to have a negative General Fund revenue impact as high as \$40.74 million annually. This estimate may be overstated, since it is unknown how many directors and staff would be certified each year to claim the credit, as well as the professional development level that each would achieve.

Business-Supported Child Care Tax Credit

The impact of the proposed Business-Supported Child Care Tax Credit is unknown. The amount of expenses that would qualify for the credit is unknown. This credit is similar to the Day-Care Facility Investment Tax Credit, which was deemed obsolete in 2014 since no taxpayers had claimed the credit during the preceding five calendar years.

9. Specific agency or political subdivisions affected:

Department of Taxation
Department of Social Services

10. Technical amendment necessary:

The Department of Social Services ("DSS") recommends the following technical amendments:

Page 1, Line 23, after Services

Strike: *and the Virginia Early Childhood Foundation*

Insert: *or a contractor that the Department of Social Services may engage for this service.*

Page 2, Line 90, after claimed.

Strike: *If a director or staff member claims a credit pursuant to subdivision B 1, he shall not claim a credit pursuant to this section in any subsequent taxable year.*

Page 2, Line 114, after of

Strike: *Education*

Insert: *Social Services*

Page 3, Line 129, after 2018

Insert: *except for the child care facility directors and child care facility staff tax credit which shall be available for taxable years beginning on and after January 1, 2019*

Page 3, Line 138

Insert: *2. The Department of Social Services regulations establishing professional development criteria for child care facility directors and child care facility staff shall be effective in 280 days or less from enactment of this act.*

11. Other comments:

Federal Child Care Benefits

Dependent Care Benefits Exclusion

For federal income tax purposes, employees may exclude certain dependent care benefits from income:

- Amounts an employer paid directly to either the taxpayer or the care provider for the care of the child while the taxpayer was working.
- The fair market value of care in a daycare facility provided or sponsored by an employer, and
- Pre-tax contribution a taxpayer makes under a dependent care flexible spending arrangement.

This exclusion is limited to the lesser of:

- The total amount of dependent care benefits you received during the year;
- The total amount of qualified expenses you incurred during the year;
- The taxpayers earned income;
- The taxpayers spouses earned income; or
- \$5,000 (\$2,500 if married filing separately).

Child and Dependent Care Expense Credit

Under federal law, a nonrefundable credit is permitted for a portion of qualifying child and dependent care expenses paid for purposes of allowing the taxpayer to be gainfully employed. To be eligible for the credit, the taxpayer must incur employment-related expenses in providing care for one or more qualified individuals. For purposes of this credit, the term “qualifying individual” means a dependent of the taxpayer who has not attained age 13; a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself and who has the same principal place of abode as the taxpayer for more than half of the taxable year; or the taxpayer’s spouse, if the spouse is incapable of caring for himself or herself and has the same principal place of abode as the taxpayer for more than half of the taxable year.

Qualifying employment-related expenses include expenses paid for household services and for the care of a qualifying individual that allow the taxpayer to work or look for work. Services rendered outside the home qualify if they involve the care of a qualified individual who regularly spends at least eight hours per day in the taxpayer’s home.

The maximum amount of employment-related expenses to which the credit may be applied is \$3,000 for one qualifying individual or \$6,000 for two or more qualifying individuals, less the amount excludable by the taxpayer for any employer-provided dependent care assistance. The amount of the credit is equal to the amount of qualified expenses multiplied by the applicable percentage, as determined by the taxpayer’s adjusted gross income (“AGI”). Taxpayer’s with an AGI of \$15,000 or less use the highest applicable percentage of 35 percent. For taxpayer’s with an AGI over \$15,000, the credit is reduced by one percentage point for each \$2,000 of AGI, or fraction thereof, in excess of \$15,000. The minimum applicable percentage of 20 percent is used by taxpayers with an AGI greater than \$43,000. Thus, the maximum dependent care credit amount is \$1,050 for one qualifying individual and \$2,100 for two or more qualifying individuals.

Qualifying employment-related expenses are considered in determining the credit only to the extent of earned income. For married taxpayers, expenses are limited to the earned income of the lower-earning spouse. Generally, if one spouse is not working, no credit is allowed. However, if the nonworking spouse is physically ill or mentally incapable of caring for himself or herself or is a full-time student at an educational institution for at least five calendar months during the year, the law imputes an earned income amount, for each month of disability or school attendance, of \$250 if there is one qualifying individual or of \$500 if there is two or more qualifying individuals.

Taxpayers may not claim the dependent care benefits exclusion and a child and dependent care expenses tax credit for the same childcare expenses.

Federal Child Credit and Recent Changes under the Tax Cuts and Jobs Act

Taxpayers are also permitted to claim the federal child tax credit for each qualifying child under the age of 17. For taxable years before January 1, 2018, the amount of the credit was equal to \$1,000 per qualifying child. This credit was not refundable and was phased out for taxpayers with a modified AGI over \$75,000 (\$110,000 for married filing jointly).

On December 22, 2017, the Tax Cuts and Jobs Act (Public Law 115-97) was enacted. This federal tax reform legislation made significant changes to the child tax credit. These changes include:

- Increasing the credit to \$2,000;
- Allowing credits of up to \$1,400 to be refunded; and
- Increasing the income threshold for phasing out the credit to modified AGI over \$200,000 (\$400,000 for married filing jointly).

The Tax Cuts and Jobs Act also eliminated personal exemptions for dependents, and as a result, taxpayers with children will no longer be able to claim an exemption for their children on federal tax returns. The elimination of these exemptions will significantly increase the federal adjusted gross income ("FAGI") of taxpayers with multiple children. For federal income tax purposes, this increase in tax liability has been offset with the increases to the child tax credit. Because Virginia uses FAGI as a starting point to calculate Virginia taxable income, but does not have a similar child credit, taxpayers with multiple children may have a significantly higher Virginia tax liability.

Virginia Child Care Tax Incentives

Deduction for Child and Dependent Care Expenses

In Virginia, taxpayers may deduct the amount of employment-related expenses on which the federal child and dependent care credit is based. The amount of employment-related expenses that may be deducted is limited to the amount actually used in computing the federal child and dependent care credit. As a general rule, taxpayers are limited to a maximum deduction of \$3,000 for one child and \$6,000 for two or more dependents, or the earned income of the spouse having the lowest income, whichever is less.

Day Care Facility Investment Tax Credit

For taxable years beginning on and after January 1, 1997, but before January 1, 2014, taxpayers were permitted to claim an individual or corporate income tax credit in an amount equal to 25 percent of all expenditures paid or incurred by such taxpayer to establish a child day-care facility to be used primarily by the children of such taxpayer's employees. The credit was subject to an annual credit cap of \$100,000, and taxpayers were limited to a credit of 25,000.

The Day-Care Facility Investment Tax Credit was not subject to a statutory sunset date. However, the credit was deemed obsolete during 2013 because no taxpayers claimed the credit for the five preceding taxable years. Therefore, taxpayers are not permitted to claim the credit for taxable years beginning on or after January 1, 2014, unless expressly authorized to do so in the future by the General Assembly.

Other States

For the Tax Year 2016, twenty-five states (including Virginia) and the District of Columbia provided a tax credit or deduction based on the federal child and dependent care tax credit. Out of these states, twelve (Arkansas, Colorado, Hawaii, Iowa, Louisiana, Main, Minnesota, Nebraska, New Mexico, New York, Oregon, and Vermont) allow a refundable credit.

Proposed legislation

This bill would provide a series of partially refundable income tax credits for certain child care expenses paid by individuals and businesses, owning or operating a child care facility, and directors and staff at child care facilities.

For purposes of these credits:

- “Child” would be defined as a child under the age of six, and
- “Child care facility” would be defined as a facility that primarily serves children under the age of six.
- “Child care expenses” would be defined as an expenditure paid by a parent for his child to attend a child care facility.
- “Quality rating” would be defined a child care facility’s level in the Virginia Quality Rating and Improvement System as determined by the Department of Social Services and the Virginia Early Childhood Foundation.

Child Care Expenses Tax Credit

This bill would permit a parent to claim an individual income tax credit for child care expenses. The amount of the credit would be equal to a percentage of the federal income tax credit for child care expenses, for which the parent is eligible, multiplied by a percentage determined by the quality rating of the child care facility that the child attends. The percentage of the federal credit would be computed based on the amount of such credit before it is reduced by the amount of the parent’s federal income tax liability as follows:

Parent’s FAGI	Percentage of Federal Credit
\$25,000 or less	50 percent
\$25,001 to \$35,000	30 percent
\$35,001 to \$60,000	10 percent
\$60,001 or more	The lesser of \$25 or 10 percent of the federal credit.

The result of this first computation would then be required to be multiplied by a second percentage based on the quality rating of the child care facility that the child attends as follows:

Quality Rating of Attended Child Care Facility	Percentage of the Base Child Care Expense Tax Credit.
Level 5	200 percent
Level 4	150 percent
Level 3	100 percent
Level 2	50 percent
Level 1 or nonparticipating facility	0 percent

A parent with multiple children would be required to compute the credit of each child separately. If a child receives services in more than one child care facility in a single year, the facility with the highest quality rating would be used to compute the credit. If more than one parent is eligible to claim a credit for a single child, only one parent would be permitted to claim such credit.

Business-Supported Child Care Tax Credit

This bill would provide a credit that may be used against the individual income tax, corporate income tax, or tax that is imposed on estates and trusts to businesses for eligible child care expenses. The amount of the credit would be the amount of the business’s eligible child care expenses multiplied by an amount based on the quality rating of the child care facility. For purposes of this credit, “eligible child care expenses” would include a business’s:

- Expenses to construct, renovate, expand, or repair a child care facility, purchase

equipment for a facility, and maintain or operate a facility, not to exceed \$50,000 in expenses per taxable year;

- Payments made to a child care facility for child care services to support the business's employees, not to exceed \$5,000 per child per taxable year; and
- Purchase of child care slots at child care facilities actually provided or reserved for children of the business's employees, not to exceed \$50,000 per taxable year.

The amount of the business's eligible child care expenses would then be multiplied by a percentage based on the quality rating of the child care facility as follows:

Quality Rating Child Care Facility	Percentage of Qualified Child Care Expenses
Level 5	20 percent
Level 4	15 percent
Level 3	10 percent
Level 2	5 percent
Level 1	\$0

A business would also be permitted to earn an additional credit that may be used against the individual income tax, corporate income tax, or tax imposed on estates and trusts for a donation to a child care resource agency. Such credit would be limited to \$5,000 per taxpayer per taxable year. For purposes of this credit, "child care resource agency" would be defined as a private agency that contracts with the Department of Education to provide information and services to parents and child care providers.

This bill would prohibit a business from claiming this credit to the extent an expenditure or donation was used to claim the federal charitable deduction, or the Virginia Day-Care Facility Investment Tax Credit, Neighborhood Assistance Act Tax Credit, or Education Improvement Scholarships Tax Credit.

Child Care Provider Tax Credit

This bill would permit the owner or operator of a child care facility to claim an individual income tax credit for each eligible child attending such facility. The amount of the credit would be equal to the number of eligible children multiplied by an amount determined by the quality rating of the child care facility that the eligible child attends, as follows:

Quality Rating of Requesting Child Care Facility	Credit Amount per Child
Level 5	\$1,500
Level 4	\$1,250
Level 3	\$1,000
Level 2	\$750
Level 1	\$0

For purposes of this credit, "number of eligible children" would be defined as the average monthly number of children, rounded up to the next integer, who either participate in the Child Care Subsidy Program administered by DSS or are foster children in the custody of DSS.

Child Care Directors and Staff Tax Credit

This bill would also provide an individual income tax credit for directors and staff at a child care facility. The credit would be determined by the professional development level of each individual as follows:

Directors and Staff Professional Development	Credit Amount
Level 4	\$3,000
Level 3	\$2,500
Level 2	\$2,000
Level 1	\$1,000

Beginning in Taxable Year 2019, these amounts would be required to be adjusted annually for each taxable year by the percentage increase in the Consumer Price Index United States city average for all urban consumers (CPI-U), as prepared by the United States Department of Labor, Bureau of Labor Statistics, calculated as of December 1 of the previous year.

This bill would require DSS to promulgate regulations establishing professional development criteria for directors and staff. The criteria would define four levels representing cumulative advancement for directors and staff, with the fourth level representing the highest level of advancement. The criteria would be required to be designed to achieve the goal of ensuring high-quality child care in Virginia. DSS would be required to provide documentation of certification to directors or staff who provide evidence to DSS that they meet the criteria for an applicable level.

To receive this credit, a director or staff member would be required to file with his or her income tax return a certification provided by DSS verifying that he or she meets the requirements and qualifications of a director or staff member for the level claimed. If a director or staff member claims a credit, he or she would not be permitted to claim this credit in any subsequent year.

Refundability and Recapture of Credits

Each of the credits that would be provided in this bill would be refundable if the taxpayer's FAGI is less than or equal to \$25,000. Any amount of credits in excess of the taxpayer's tax liability would be treated as an overpayment of taxes, and the Department would be required to refund such amounts. In contrast, these credits would not be refundable for taxpayers that have an FAGI over \$25,000. In such cases, the taxpayer would be permitted to carry forward any unused credit for up to five years.

If any tax credit that would be provided under this bill is obtained without meeting the requirements of the applicable credit, including by fraud or misrepresentation, such credit would be recaptured, with interest, and the taxpayer's income tax liability would be increased by a corresponding amount. This recapture provision would generally be subject to a three-year statute of limitations, but may be extended to six years in the case of a false or fraudulent return with the intent to evade payment of taxes.

This bill would be effective for taxable years beginning on or after January 1, 2018, but before January 1, 2023.

cc: Secretary of Finance

Date: 1/24/2018 RWC
DLAS HB700F161