

## CCH Tax Research Consultant, BUSEXP: 55,000, Employer Child Care Expense Credit

**General business credit includes credit for expenses incurred by an employer in providing child care for employees. The credit amount is equal to 25 percent of the qualified child care expenses plus 10 percent of the qualified child care resources and referral expenditures. The total credit allowed for a given tax year cannot exceed \$150,000. Recapture of amounts with respect to property will increase tax liability.**

Employers are allowed an income tax credit for expenses incurred during the tax year arising from child care furnished to employees. See BUSEXP: 54,000 for discussion of the general business credit. The amount of the employer-provided credit for a given tax year is the sum of 25 percent of the qualified child care expenditures and 10 percent of the qualified child care resource and referral expenditures of the taxpayer.<sup>1</sup> The maximum amount of the employer-provided credit allowable in any given tax year is \$150,000.<sup>2</sup>

### **EXAMPLE**

Sampson Creations, Inc., establishes a comprehensive child care program for its employees. During the current tax year, Sampson has \$200,000 in qualified child care expenditures and \$50,000 in qualified child care resource and referral expenditures. Sampson's employer-provided child care credit, as determined under Code Sec. 45F, would be \$55,000 ( $[\$200,000 \times 25\%] + [\$50,000 \times 10\%]$ ).

*Qualified child care expenditure.* An expense may be considered a qualified child care expenditure if any one of the following circumstances applies:

- The expenditure is made to acquire, construct, rehabilitate, or expand property, provided that all of the following conditions are met with respect to the property: First, the property must be used as part of a qualified child care facility of the employer. Second, a deduction for depreciation or amortization must be allowable with respect to the property. Third, the property must not constitute part of the principal residence of the employer, or of any employee of the employer.<sup>3</sup>
- The expenditure is for the operating costs of a qualified child care facility of the employer, including costs related to the training of employees, to scholarship programs, and to the providing of increased compensation to employees with higher levels of child care training.<sup>4</sup>
- The expenditure is made under a contract with a qualified child care facility to provide child care services to the employees of the employer.<sup>5</sup>

However, an expense will not be considered a qualified child care expenditure if it exceeds the fair market value of the care provided.<sup>6</sup>

### **PLANNING NOTE**

Taxpayers claiming the employer-provided child care credit should thoroughly document the costs of child care facilities in their geographic area. This may protect the employer from IRS claims that the child care expenses are excessive. Until the IRS offers guidance on what will be used to determine the fair market value of child care services, there will be uncertainty in this area.

### **EXAMPLE**

Sampson Creations, Inc., prior to establishing its child care programs, retained a prominent consulting firm to ascertain the fair market value (FMV) of child care services in its geographic area. The consulting firm's results showed the FMV of child care services provided by Sampson to be \$150,000 in qualified child care expenditures and \$30,000 in qualified child care resource

and referral expenditures. Sampson's facility is located in a designated high-crime area requiring additional security. However, the consulting firm's research concluded that the FMV of child care services of companies in other geographic areas located within high-crime areas to be consistent with the amounts spent by Sampson Creations, Inc. for its child care program. Accordingly, Sampson would appear to meet the fair market value requirement under the new law.

*Qualified child care facility.* A qualified child care facility is a facility the principal use of which is to provide child care assistance (unless the facility is the principal residence of the operator of the facility), and that meets the requirements of all applicable state and local laws and regulations for the area in which it is located, including the licensing requirements applicable to a child care facility.<sup>7</sup>

A qualified facility must meet the following conditions:

- Enrollment in the facility must be open to the employees of the employer seeking the credit during the tax year;
- If the facility is the principal trade or business of the employer, at least 30 percent of the enrollees at the facility must be the dependents of the employer's employees; and
- The use of the child care facility cannot discriminate in favor of highly-compensated employees.<sup>8</sup>

*Qualified child care resource and referral expenditure.* A qualified child care resource and referral expenditure is any amount paid or incurred under a contract to provide child care resource and referral services to an employee of the employer. Qualified services can not discriminate in favor of highly compensated employees.<sup>9</sup>

*Determination of taxpayer status of corporations, partnerships, estates, and other entities.* The rules applicable to corporations and partnerships under the welfare-to-work provisions of the Code also apply to the child care credit. Similar provisions apply with respect to the issue of pass-through in the case of estates and trusts. For discussion of rules applicable to welfare-to-work credit, see BUSEXP: 54,860. Regulations issued by the Secretary of Treasury apply in the case of partnerships.<sup>10</sup>

*Double benefit prohibited.* In order to avoid duplication of benefits, an employer's basis in property with respect to which the child care credit applies will be reduced by the amount of the credit given. If there is a recapture amount (as discussed below) determined with respect to the employer's property during the tax year, the basis of that property immediately prior to the event resulting in recapture will be increased by the recapture amount.<sup>11</sup>

Moreover, no further deduction under other sections of the Code will be allowed with respect to the child care credit.<sup>12</sup>

*Recapture of acquisition and construction credit.* If a recapture event occurs by the close of the tax year with respect to a qualified child care facility of the employer, then the tax liability for that year must be increased by an amount equal to the applicable recapture percentage multiplied by the aggregate decrease in the general business credit as if all previously allowed employer-provided child care credits with respect to the employer's child care facility had been zero.<sup>13</sup>

The applicable recapture percentage is set forth in the following table, for purposes of which "Year 1" begins on the first day of the taxable year in which the qualified child care facility is placed in service by the taxpayer.<sup>14</sup>

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Year of occurrence of recapture event	Applicable recapture percentage
Years 1 – 3	100
Year 4	85
Year 5	70
Year 6	55
Year 7	40
Year 8	25
Years 9 and 10	10

Year 11 and subsequent years

0

*Recapture defined.* A recapture event is defined as either (1) termination of the operation of the facility as a qualified child care facility or (2) a change of ownership of a qualified child care facility, unless the purchaser, prior to acquisition, agrees in writing to assume the seller's recapture liability.<sup>15</sup>



#### CAUTION

Practitioners should note that the recapture penalty is 100 percent for the first three years that a qualified facility is in operation. The 100 percent recapture penalty may be rather severe, especially if employees fail to take adequate advantage of the benefit of using a qualified child care facility, thus forcing the employer to terminate its interest.

*Special rules applicable to recapture.* The tax will be increased by the applicable recapture percentage only with respect to credits that the employer used to decrease its liability. As to credits that were not used to reduce tax liability, the carryforwards and carrybacks are to be adjusted appropriately. For discussion of carryforwards and carrybacks in this context, see BUSEXP: 54,058.<sup>16</sup>

Additionally, any increase in tax resulting from the recapture provisions of the Act will not be treated as a tax for purposes of determining the amount of credit for purposes of determining the amounts of other credits or determining the amount of alternative minimum tax.<sup>17</sup>

Finally, an increase in tax under the recapture provisions of the Act will not apply to termination of operation by the facility if that termination results from a casualty loss, to the extent that the loss is restored by reconstruction or replacement within a reasonable period of time.<sup>18</sup>

The credit is calculated and reported on Form 6765, Credit for Increasing Research Activities.

#### Footnotes

- 1 Code Sec. 45F(a).
- 2 Code Sec. 45F(b).
- 3 Code Sec. 45F(c)(1)(A)(i).
- 4 Code Sec. 45F(c)(1)(A)(ii).
- 5 Code Sec. 45F(c)(1)(A)(iii).
- 6 Code Sec. 45F(c)(1)(B).
- 7 Code Sec. 45F(c)(2)(A).
- 8 Code Sec. 45F(c)(2)(A).
- 9 Code Sec. 45F(c)(3)(B).
- 10 Code Sec. 45F(e).
- 11 Code Sec. 45F(f)(1).
- 12 Code Sec. 45F(f)(2).
- 13 Code Sec. 45F(d)(1).
- 14 Code Sec. 45F(d)(2).
- 15 Code Sec. 45F(d)(3).
- 16 Code Sec. 45F(d)(4)(A).
- 17 Code Sec. 45F(d)(4)(B).
- 18 Code Sec. 45F(d)(4)(C).