STATE OF MICHIGAN
DEPARTMENT OF TREASURY

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TO: Stewart Binke, Administrator, Tax Policy Division

FROM: Bryan Kurtz, David Foos Administrative Law Specialists, Tax Policy Division

SUBJECT: ATL 19613 Tri-Share Child Care Pilot Program

Background: Under the Tri-Share pilot program, the cost of childcare is shared equally by an employer, the employee, and the State of Michigan, with coordination being provided regionally by a facilitator hub. Employee eligibility is determined based on the employee's family size and household income. Household income must be between 150%-250% of the Federal Poverty Level (FPL).[1] Further, the employee must not be eligible for the Development and Care Program (commonly referred to as the childcare subsidy). Employers have flexibility in deciding which family will receive a childcare slot. The selection could be based on a first come, first serve process, employee lottery/random selection or employee need (i.e., closest to 150% FPL).[2]

The Michigan Women's Commission has raised the following four questions regarding the pilot program:

1. Should the employee portion be pre-tax or after-tax when deducted from paychecks?
2. Should the employer portion be considered taxable income or not?
3. If the employee has a flexible spending account (FSA), are they able to use it for their portion of the childcare? The employee would pay us and then ask for reimbursement from the FSA account?
4. Will the Tri-Share program interfere with the child tax credit eligibility?[3]

Short Answers:

1. Federal law and the employer plan's terms will determine whether the employee contributions may be made with pre-tax dollars. A plan that qualifies as a dependent care assistance program (DCAP) will allow for pre-tax contributions.
2. Under a DCAP, employees may exclude employer contributions from federal income equal to the smallest of: (1) the employee's earned income or the earned income of the lower-

[1] For a family or household of 4 persons living in one of the 48 contiguous states or the District of Columbia, the poverty guideline for 2021 is $26,500. This amount changes based on family size. See https://www.healthcare.gov/glossary/federal-poverty-level-fpl/.

[2] See FAQs https://www.michigan.gov/documents/mwc/MI_Tri-Share_Frequently_Asked_Questions_727180_7.pdf.

[3] Treasury does not provide tax advice or counsel to taxpayers. Taxpayers should seek such advice from a tax professional. Further, the Michigan Women's Commission should consult with the IRS to determine whether the program will comply with federal requirements.

earning spouse if the employee is married, (2) dependent care benefits received, or (3) the statutory exclusion amount. Note, the State assistance amount likely is taxable unearned income for federal tax purposes and included in adjusted gross income (AGI) for State income tax purposes.
3. Yes, the FSA would operate in the same manner as other FSAs where the employee requests reimbursement of paid qualifying expenses from the FSA administrator.
4. A program established as a DCAP should not interfere with the federal child tax credit; however, employees cannot claim qualifying expenses excluded from income when computing the federal credit.

Analysis: Voluntary fringe benefits are sometimes called employee paid benefits. The benefit may be fully funded by employees or funded by both the employer and employee.[4] Voluntary deductions may be taken out of an employee's paycheck on a pretax or after-tax basis as long as the employee provides written authorization. Internal Revenue Service (IRS) publication 15-B discusses employer fringe benefits including dependent childcare. Dependent childcare is a voluntary fringe benefit that the IRS allows employers to offer to employees by allowing employees to contribute to a plan on a pretax basis. These plans provide for the exclusion of all or part of the value of the benefit from the recipient's gross income.

Internal Revenue Code ("IRC") §129[5] allows employers to provide dependent care assistance benefits to employees on a tax-free basis utilizing a DCAP or FSA. A DCAP is a separate written employer plan for the exclusive benefit of employees to provide employees with dependent care assistance.[6] The IRS views a dependent care FSA as a DCAP. Most DCAPs are structured so that employees make contributions on a pre-tax basis through an IRC §125 cafeteria plan.[7]

IRC §129 excludes from the employee's gross income amounts paid or incurred by the employer for dependent care benefits provided to the employee if the assistance is furnished pursuant to a DCAP. The amount that can be excluded from income is limited to the smallest of (1) the employee's earned income or the earned income of the lower-earning spouse if the employee is married, (2) dependent care benefits received, or (3) the exclusion amount.[8] Further, the employer can deduct amounts paid or incurred under a qualified DCAP. The plan however must meet certain statutory requirements. One such requirement is the plan cannot discriminate in favor of highly compensated employees or their dependents. IRC §129(a)(2) limits the benefit

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[4] See Voluntary employee benefits - a simple guide | Colonial Life
[5] 26 USC §129.
[6] The program must provide dependent care assistance exclusively to employees on a basis that does not discriminate in favor of highly compensated employees or their dependents. IRC §129(d)(3) suggests that the employer may establish classifications of non-highly compensated employees who qualify under the program. Clarification should be sought from the IRS regarding proposed employee classes. If the plan does not meet the requirements to be a DCAP, it will still be treated as a DCAP in the case of employees who are not highly compensated employees.
[7] In general, the term "cafeteria plan" means a written plan under which— (A) all participants are employees, and (B) the participants may choose among 2 or more benefits consisting of cash and qualified benefits.
[8] Section 9632 of the American Rescue Plan Act of 2021 (ARP), Pub. L. 117-2, 135 Stat. 4 (March 11, 2021), increases the exclusion for employer-provided dependent care under IRC § 129 to $10,500 (half that amount in the case of a married individual filing separately) with respect to any taxable year beginning after December 31, 2020, and before January 1, 2022. The exclusion resets back to $5,000 in 2022. Amounts more than these exclusions are taxable to the employee.

amounts that may be excluded from taxation with respect to dependent care assistance services provided during the taxable year.

Because the IRS recognizes an IRC §125 cafeteria plan FSA[9] as a DCAP, an employee may contribute to the plan through salary reduction, and the FSA may reimburse the employee for dependent care expenses incurred by the employee during the year. The reimbursements of dependent care expenses less than the IRC §129 limitations are excluded from gross income. Reimbursements that are in excess of the limitations are not excludable under IRC §129 and are includable in the employee's gross income and wages. The limitation under IRC §129 applies to amounts paid or reimbursed for dependent care services provided during the taxable year of the employee, not the tax year of the plan.

In response to the first three questions, the employee portion will be either pre-tax or after-tax depending on the plan offered by the employer. Under a cafeteria style FSA, the employee contributions would be pre-tax and may be used for qualified childcare expenses. IRC §129 excludes from the employee's gross income amounts paid or incurred by the employer for dependent care assistance benefits provided to the employee if the assistance is furnished pursuant to a DCAP. Employee reimbursements less than the IRC §129 limitations are excluded from income and the excess reimbursement is taxable to the employee.

The Child and Dependent Care Credit[10] is a federal tax credit specifically for working people to help offset the costs associated with caring for a child or dependent with disabilities. This is a tax credit applied against tax liability, rather than a tax deduction applied to the tax base when determining tax liability. A tax deduction reduces federal taxable income (FTI) and AGI, starting points for state taxes, and the amount of income on which the taxpayer must pay tax. As a federal tax credit, however, the credit will not affect state income tax which is based on FTI or AGI. Whether a person qualifies for the federal credit is determined by federal law, not state law. Several requirements that must be met to claim the federal credit, including:

1) The taxpayer (and spouse, if married) must have "earned income," meaning money earned from a job. Non-work income, such as investment profits, does not count.
2) The taxpayer must have paid for the care so that they could work or look for work. Being a full-time student or a parent unable to care for themselves does count as "working" for the purposes of the credit, even if no income is received.
3) If the taxpayer is married, the taxpayer must file a joint tax return.
4) The taxpayer must provide the name, address, and Taxpayer Identification Number ("TIN") of the person who provided the care.

Unless otherwise precluded by federal law, the program should not interfere with otherwise eligible persons from being able to claim the federal child tax credit.[11] However, it should be noted that for amounts an employer contributes to employee childcare expenses or amounts an

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[9] While dependent care FSAs are the most popular vehicle, the IRC §129 income exclusion also applies to employer-provided on-site childcare and direct employer payment or reimbursement of dependent care expenses (i.e., no salary reduction contributions). See http://help.erisafire.com/en/articles/5087864-need-to-know-faqs-arpa-dependent-care-fsa-change

[10] See IRC §21 - Expenses for household and dependent care services necessary for gainful employment.

[11] The conclusion presumes the program meets the federal requirements and is established as a DCAP or FSA.

employee has withheld from pay on a pre-tax basis, those amounts must be subtracted from allowable expenses in computing the federal credit. In other words, employees cannot claim the IRC §21 dependent care credit for amounts excluded from income.[12]

Additional Question: A question not posed above is whether the State contribution to the employee is subject to tax? Gross income under the IRC is broad and means all income from whatever source derived.[13] Taxable income under the Michigan Income Tax Act (ITA) begins with AGI as defined under the IRC.[14] AGI is then subject to certain statutory adjustments. Thus, amounts included or excluded from gross income at the federal level are generally given the same effect for Michigan income tax. Amounts included in federal AGI flow through to the Michigan income tax base unless there is a statutory adjustment provided for in the ITA. The ITA has no adjustment for childcare assistance payments.

In determining whether the parent would have to recognize taxable income from the childcare subsidy payments made by the State, we believe the IRS is likely to conclude it is not taxable. There is no statutory exclusion from income for a welfare benefit that appears in the IRC, and IRS Publication 525 does not address childcare subsidies in the discussion of welfare benefits, some of which are taxable income and others non-taxable.[15] However, under the so-called "General Welfare Doctrine," the IRS treats payments from legislatively created social benefit programs that promote general welfare as excluded from AGI. To be excluded from AGI, the payment must 1) be made from a governmental general welfare fund; 2) be for the promotion of general welfare (i.e., need-based and not available to everyone); and 3) not be for services furnished by the recipient.[16]

In analyzing the application of the general welfare doctrine for other welfare benefits provided by states, federal courts have applied an "ultimate beneficiary" test, which considers whether the recipient of the state-sponsored benefit was the intended beneficiary of that benefit.[17] In *Bannon*, the IRS argued that state payments received by a mother as compensation for the nonmedical care she provided her daughter were subject to tax whereas the mother contended the income received was a government welfare benefit or subsidy and was not taxable. The court agreed with the IRS by concluding the daughter was the ultimate beneficiary, and stating, "[r]egardless of how provider remuneration is paid, it is clear to us that under this scheme the intended beneficiary of the welfare payments is the recipient of the services, in this case Carol [the daughter], not the provider, the petitioner." Therefore, the court concluded, "Petitioner is merely allowed, unlike the parent of a minor child whom the State expects to provide the services

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[12] See IRC §129(e)(7).
[13] See IRC §61.
[14] MCL 206.30(1).
[15] https://www.irs.gov/publications/p525#en_US_2020_publink1000229108
[16] https://www.irs.gov/pub/irs-wd/0648027.pdf.
[17] See *Bannon v. Comm'r of Internal Revenue*, 99 T.C. 59, 62 (U.S.T.C. 1992) dealing with payments a mother received from the state of California for in-home healthcare of her daughter. Also citing to, *Graff v. Commissioner*, 74 T.C. 743, 753-754 (1980), affd. per curiam 673 F.2d 784 (5th Cir. 1982). There rental property owners received lower interest rates so tenants could receive lower rents. The tenants had no income. The Supreme Court, referring to a New York State low-income housing subsidy, has said: "In a real sense, it no more embodies the attributes of income or profits than do welfare benefits, food stamps, or other government subsidies." *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 855 (1975).

without compensation, to be compensated for a portion of the time she provides supportive services to her daughter."

As *Bannon* illustrates, the "ultimate beneficiaries" test should be applied consistent with the overall intent of the legislative scheme.[18] Indeed, the IRS has recently recognized as much based on its recent analysis and conclusion regarding the taxation of a state-sponsored health-care subsidy for employees. Considering the scope and purpose of the health-care subsidy, the IRS ultimately concluded "the purpose of the subsidy is to defray all or part of the cost of the health insurance premium paid by the employee," even though the dependents of the employee covered under the insurance might actually be the ones that receive the healthcare services funded by that subsidy.[19] Thus, it seems likely that simply defraying necessary employee costs is a perfectly legitimate purpose of the subsidy and the IRS could accept that purpose rather than trace the benefits through to the children.

To the extent the Tri-Share subsidy defrays the cost of necessary childcare that the parents need to remain employed, it would be similar to a state-sponsored health-care subsidy, and assuming the program meets the other prerequisites of the "General Welfare Doctrine," we generally believe the subsidy is exempt from the parent's income based on how the IRS has examined similar matters.[20]

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[18] The court noted the test is not to be read "to mean the class of persons last in line to receive the benefit; rather, they denote the class of persons definitely established by law as the intended beneficiaries of the subsidy."
[19] See IRS Publication 525. Employees are the recipient of a fringe benefit if they perform services for which the fringe benefit is provided even if it's given to another person, such as a member of your family.
[20] If desired, the agency may wish to seek IRS guidance if a formal and more definitive analysis is needed. Because this is a federal question, and we can only speculate on the tax treatment of the subsidy payment based on related examples. Depending on how the IRS would rule on the income treatment to the employee would dictate if a Form 1099 needs to be issued to the employee.