Tax Credits and DCAPs

Overview

Help with understanding federal tax credits relating to child and dependent care costs and with employer DCAPs.

- The Child and Dependent Care Credit
- Dependent Care Assistance Programs
- The Earned Income Credit
- The Child Tax Credit
- The Making Work Pay Credit

The costs of child care and other dependent care can be a strain on a family's budget. But some government help does exist in the form of federal tax credits (the Child and Dependent Care Credit, Child Tax Credit, and the Earned Income Tax Credit) and employers' Dependent Care Assistance Plans (commonly called DCAPs). The following information will help you to understand what the programs are, whether you qualify for help, and how to get it.

This guide is a summary of these tax programs. Before deciding how they apply to your specific situation, it's important to read through the rules and restrictions in the publications of the Internal Revenue Service (IRS) or to check with your own accountant or tax adviser. Information here is current as of January 2011 for the 2010 tax year.

The Child and Dependent Care Credit

The Child and Dependent Care Credit can reduce the taxes your family owes (or increase your tax refund) if you pay for child care in order to work or, in certain cases, if you pay for the care of a spouse or other dependent. The credit is based on your family's actual care expenses and varies with your family's income. It is available to families at all income levels.

Who may receive the credit?

You are eligible for the Child and Dependent Care Credit if *all* of the following are true:

- You paid for child care in the previous year for a child under the age of 13 who lived with you.
- You needed the child care in order to work or look for work. (If you are married, both you and your spouse must have needed the care in order to work or look for work, one spouse must have been a full-time student for at least five months in the year, or one spouse must have been unable to care for himself or herself.)
- You have earned income. (Child care expenses up to the level of your earned income are considered for the credit. If you are married and filing a joint return, child care expenses up to the lower of your earned income or your spouse's earned income are considered for the credit. Special rules apply for calculating the earned income of a spouse who was a full-time student or disabled during the tax year.)

- You identified the care provider on your tax return, including name, address, and Social Security or tax identification number (unless your caregiver is a tax-exempt organization such as a church or school).

You are also eligible for the credit if you work or are looking for work *and* one of the following is true:

- Your spouse has a mental or physical disability and is unable to care for himself or herself.
- You can claim another person as a dependent who is disabled and unable to care for himself or herself.

Children's ages

In general, you can only claim the credit for a child under the age of 13 whom you can claim as a dependent. If the child turned 13 during the year, the child counts as a dependent for purposes of the credit only for the part of the year when he or she was under the age of 13.

Divorce

If you were divorced, were legally separated, or lived apart from your spouse during the last six months of the tax year, you may be able to take the credit or the exclusion even if your child is not your dependent. Special rules about the effect of divorce and separation on the credit are explained in the IRS's Instructions for Form 2441 and in its Publication 503: *Child and Dependent Care Expenses*.

How much of a credit will I get?

The amount of your credit will depend on the amount you pay during the year for care and on your income. The credit will be between 20 and 35 percent of the cost of your care (up to a cap of $3,000 for one child or dependent or $6,000 for two or more). The largest possible credit is $2,100 -- 35 percent of $6,000.

What costs are included in figuring out the amount of the credit?

The costs of most forms of child care or other dependent care count when you're applying for the credit. This includes care offered at child care or adult day care centers, family child care, day camps, school-based programs, or care provided by a sitter or caregiver in your home -- as long as you pay those costs yourself. The care may also be provided by a relative, as long as the relative isn't your spouse, dependent, or someone who was under the age of 19 at the end of the tax year. The cost of overnight camp is not considered a child care expense for the purposes of the credit.

If you participate in an employer-sponsored DCAP, the amount you set aside may affect your Child and Dependent Care Credit.

How can I claim the credit?

To receive the credit, you need to file a separate form or schedule with your tax return. You cannot use Form 1040EZ. If you use Form 1040 or 1040a, file Form 2441. .

During the year, you need to keep track of how much you spend on child or dependent care. You also need to have basic information about each caregiver, including his or her name, address, Social Security number, and -- if your caregiver is not a tax-exempt organization -- a tax identification number, and you will need to report this information on your tax return. One way to collect this information is to have the caregiver fill out IRS Form W-10. Keep the completed Form W-10, along with canceled checks, receipts, and other records, in a separate file or another safe place (and keep these records for at least four years after the tax filing date).

Government forms and publications

The IRS provides a free publication that explains in detail what you need to do to obtain the credit. Just call 800-TAX-FORM (800-829-3676) and ask for Publication 503, which explains how to apply for the credit, or access the IRS's Web site at *www.irs.gov*.

If you file Form 1040 or 1040a, you also will need to ask for Form 2441 and the instructions that go with it.

Dependent Care Assistance Programs

Some employers have programs that help employees with child care and other dependent care expenses by making a portion of their pay exempt from federal income taxes and FICA and FUTA deductions. The programs are usually referred to as DCAPs or Dependent Care Flexible Spending Accounts (FSAs).

How does a DCAP work?

If your employer has a DCAP, you will need to enroll in the program, usually during a specified enrollment period of one or two months during the year. When you enroll, you will be asked to estimate how much money you expect to pay for care and how much you would like set aside from your paycheck. If you are not sure about what your expenses will be, it is best to *underestimate* this amount because you will forfeit any unused money at the end of the year. Equal portions of this amount will then be set aside from each of your paychecks, which will reduce your taxable income. You must then submit documentation to your employer of the payments you make to your provider -- usually in the form of receipts signed by the provider. Under the terms of most programs, you will be reimbursed throughout the year with the pay that you have set aside, and those payments will not be subject to federal tax.

The following restrictions also apply:

- The amount you set aside through your company's DCAP cannot exceed $5,000 per family each year (or $2,500 for each spouse if a couple is married and filing separate returns). If your company has a subsidy program, this limit applies to the combined amount you receive through both programs.
- Children are eligible only up to age 13, unless they are disabled and unable to care for themselves, in which case they are eligible at any age as long as they live with you for at least half the year.
- Parents must report the tax identification or Social Security number of the provider to the IRS to take advantage of the DCAP. Be sure to ask your provider for this identification number before you sign up for the program. One way to collect this information is to have the provider fill out IRS Form W-10 (available through the IRS's toll-free publication number at 800-TAX-FORM (800-829-3676.)

  Note: *Au pairs* (foreign caregivers on J-1 visas hired through any of the 11 federally sanctioned foreign *au pair* programs) are generally *not* accepted as eligible providers by most employer DCAPs.
- A parent must subtract the amount of child care or other dependent care expenses set aside in a DCAP from the amount he or she uses to calculate federal tax credits. For example, if you set aside $1,000 for care through your company's DCAP and your total care expenses for the year are $1,600, only $600 ($1,600 minus $1,000) is considered when calculating the Child and Dependent Care Credit.

Effect of a DCAP on the Child and Dependent Care Credit

A DCAP is different from the Child and Dependent Care Credit.

- You cannot apply both a DCAP and the Child and Dependent Care Credit to the same dependent care expenses.
- The amount used to calculate the Child and Dependent Care Credit will be reduced, dollar for dollar, by the amount set aside in a DCAP.

For example, suppose parents put $3,600 into a DCAP to pay for a single child's child care expenses. Because $3,600 exceeds the maximum amount a family may use to calculate the tax credit for one child (currently $3,000), no credit could be claimed for that year. However, if the family only put $1,000 into a DCAP, they could use the remaining $2,000 of expenses in calculating their Child and Dependent Care Credit.

Maximum expenses that qualify for the tax credit	$3,000
Money contributed to a DCAP	- 1,000
Eligible amount for tax credit	$2,000

You can also use this calculation for more than one child. However, the current maximum for expenses in calculating the Child and Dependent Care Credit for two or more children is $6,000.

DCAP versus the Child and Dependent Care Credit

Regardless of income level, families should compare both the DCAP and Child and Dependent Care Credit to determine which is the better option for them. In general, the DCAP is more attractive for families making more than $25,000 annually. Families with an annual income of less than $25,000 should carefully compare the two options. To make the comparison, families will need to use the following information:

- filing status (single, married, etc.)
- number of dependents for whom they pay care
- amount of dependent care expenses
- income tax bracket

A word of caution about DCAPs

A DCAP is an opportunity to save money on dependent care expenses. However, investigate a DCAP arrangement thoroughly before committing money. Tax laws and IRS rules impose risks that are out of an individual's control. Consider the following:

- Any unused money in a DCAP may be forfeited.
- Social Security benefits of a DCAP user will be slightly reduced.
- DCAP rules strictly limit flexibility.

The Earned Income Credit

The Earned Income Credit (EIC) provides a credit for taxpayers whose income is below a certain level. Unlike the Child and Dependent Care Credit, the EIC can be *more* than you pay during the year in taxes. You can even receive the credit as a refund from the IRS if you had no taxes withheld. You can also choose to receive part of the EIC for 2010 in advance in your paychecks.

Who is eligible?

The EIC for families with children is available to you if all of the following are true:

- You are self-employed or you work for someone who pays you.

- You have earned income, which includes wages, salaries, and tips, but does not include bank interest, Social Security or welfare benefits, alimony, or unemployment compensation.
- Your adjusted gross income on your 2010 federal tax return is less than $43,352 if single (or $48,362 if married and filing jointly) and you have three or more qualifying children. Or, your adjusted gross income on your 2010 federal tax return is less than $40,363 if single (or $45,373 if married and filing jointly) and you have two qualifying children. Or, your adjusted gross income on your 2010 federal tax return is less than $35,535 if single (or $40,545 if married and filing jointly) and you have only one child.
- Your child or children qualify. To qualify, the child must
  - be your son, daughter, grandchild, stepson, stepdaughter, or
  - be your sister, brother, stepsister, stepbrother, or a descendant of such relatives, or
  - be your foster child -- any other child placed with you by an authorized child placement or government agency. To be eligible, the child must have lived with you for more than half the year.
  - be under age 19 by the end of the tax year, or under age 24 and a full-time student for at least five months of the year, or any age if permanently and totally disabled.
  - live in your home with you in the U.S. for more than half of the year (unless special circumstances, such as illness, divorce, school, or military service keep the child or you away from home).
- You can provide a correct and valid Social Security number for each person listed on your tax return who was born before December 31, 2010. To get a Social Security number for a child, your spouse, or yourself, file Form SS-5 with the Social Security Administration. An adult may have to file this form in person. Check in your local telephone book under U.S. Government listings for the number of the nearest Social Security Administration office, or call 800-772-1213.
- You were not a qualifying child of another person for the EIC in 2010.
- You do not file your income taxes in the category of "Married Filing a Separate Return."
- Your 2010 investment income was not more than $3,100 (for most people, this includes taxable interest and dividends, tax-exempt interest, and capital net gain income).

You can find out if you are eligible to claim the EIC by using the EITC Assistant tool on the IRS Web site at *www.irs.gov*.

How can I claim the credit?

To receive the credit, you need to fill in Schedule EIC and attach it to your Form 1040 or Form 1040A. Remember, even if you owe no tax, you can still get a credit in the form of a refund. To do this, however, you need to file a tax return.

Government forms and publications

Call 800-TAX-FORM (800-829-3676), the IRS's toll-free publication number, and ask for Schedule EIC, which you attach to either Form 1040 or Form 1040A; and Form W-5 if you wish to receive advance payments. The instructions for Form 1040 and 1040A provide the main rules for claiming the EIC. Those instructions refer some filers to Publication 596: *Earned Income Credit*, for information on more complicated situations. You can also access IRS forms and publications at the IRS Web site at *www.irs.gov*.

Free tax-preparation assistance

If your income is within the limits for the EIC, you can receive free help preparing your tax return from the Volunteer Income Tax Assistance (VITA) program. VITA is a community-based program sponsored by the IRS. Volunteers in the community receive IRS-approved training to assist in preparing individual returns. You can find out if VITA sites are in your community by calling the IRS toll-free line at 800-906-9887.

The Child Tax Credit

The Child Tax Credit (CTC) provides a tax benefit of up to $1,000 per child in 2010 for families with qualifying children under age 17. In addition, the credit is refundable, which means even families owing no income tax can receive the credit.

Who is eligible?

You may be eligible for the new CTC refund even if you owe little or no income tax and if all of the following are true:

- You earned over $3,000 in 2010. (Note: The income requirement was reduced as of 2009.)
- You can claim a qualifying child under age 17 on your 2010 tax return. The rules for a qualifying child are the same as for the EIC, except for this age rule.
- You and your qualifying child have a Social Security number or an individual taxpayer identification number (ITIN).

Note: In the case of divorced spouses, if the noncustodial spouse is allowed by the divorce or separation agreement to claim a child as a dependent, that spouse is also entitled to claim the child for the CTC. This exception does not apply to claims for the EIC, which may still be claimed by the spouse who lives with the child for more than half the year.

How much can I receive?

Qualifying families can receive up to $1,000 for each child under the age of 17 claimed on their tax return. The amount of the CTC is first used to reduce the amount of income tax owed. Families are then eligible to receive part or all of the remaining amount as a refund. Refunds are given for the *lesser* of these two amounts:

- The amount of CTC that remains after income tax liability has been eliminated.
- Fifteen percent of the family's earned income over $3,000. For example, if a worker with two children earned $15,500 in taxable income, she would owe no income tax and her full $2,000 maximum possible CTC would remain. However, 15 percent of her income over $3,000 is $1,875 ($15,500 - $3,000 = $12,500 x 15% = $1,875). Since this is less than $2,000, her CTC would be $1,875.

How can I claim the CTC?

- File a tax return using Form 1040 or Form 1040A, not Form 1040EZ. Follow the instructions and worksheet for the CTC. The CTC credit will either reduce or eliminate the amount of income tax owed. If your maximum possible CTC amount is higher than the amount of income tax owed, you may be eligible for a CTC refund and the instructions will direct you to complete Form 8812.
- Complete Form 8812, "Additional Child Tax Credit," to find out if you qualify for a CTC refund. This form will determine if a family qualifies and, if so, how much the refund will be. Form 8812 must be attached to the tax return for a family to receive the refund.

The Making Work Pay Credit

In 2010, most employees received the Making Work Pay Credit by having less income tax withheld from their pay by employers. But if you or your spouse were self-employed, or your spouse did not work, you must file the IRS Schedule M with your tax return to receive this credit, worth up to $400 for an individual and $800 for married couples who file together. Complete the Schedule M even if you received the credit in your paychecks, so that the reduced withholding of tax is accounted for. The credit is in addition to any other tax credit for which you qualify.

This credit does not require a qualifying child. In addition, a person who is working, but is a dependent, is not eligible for the credit.

This credit has been replaced for 2011 by a reduction in the amount of Social Security payroll tax that is withheld from employees' paychecks.

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