The Tax Guy by Bill Bischoff (Author Archive)

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2 Child-Care Tax Breaks So You Can Go to Work

(single page view)

As many parents know, it can cost money to go to work. Those with kids under the age of 13 may have to set aside a little extra for childcare expenses. Fortunately, a federal income tax credit can help pay the bill. It's available to all eligible parents, regardless of their income (although lower-income folks get bigger credits).

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You might also be eligible for your employer's childcare flexible spending account plan. When the FSA deal is available, it can be a bigger tax-saver than the credit.

Here's what you need to know about both breaks.

Child-Care Credit

The credit can be claimed only for childcare expenses that facilitate your going to work. If you're married and file jointly, you can generally claim the credit only if your spouse also works or goes to school full-time for at least five months during the year.

For 2010, the credit is based on up to $3,000 of eligible expenses to care for one child under 13 or up to $6,000 for two more. If your child turns 13 during the year, only expenses before his birthday count.

The credit ranges from a high of 35% of eligible expenses (limited to no more than $3,000 or $6,000 of expenses) to a low of 20%. The maximum 35% rate is available if your adjusted gross income is $15,000 or lower. The rate gradually

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drops to 20% as your AGI approaches $43,000. Above $43,000, it sticks at 20%. In fact, that 20% rate applies even if you earn gazillions because this is one break that is not phased out for high-income individuals.

Example 1: You and your spouse both work and earn healthy salaries. You have one child under 13 and $5,000 of childcare expenses. Your credit is $600 (20% x $3,000 expense cap for one child). If you have two children under 13 and $9,000 of expenses, your credit is $1,200 (20% x $6,000 cap for two or more kids).

Now for a couple tricky rules:

* Eligible childcare expenses are limited to your earned income for the year. If you're married and file jointly, expenses are limited to your spouse's earned income or yours – whichever is lower.

* If you work and your spouse is a full-time student for at least five months during the year, he or she is deemed to have $250 of imaginary earned income for each month (or part of a month) of full-time school. If you have two or more kids, the imaginary earned income is $500 for each month (or part of a month). For any given month, only one spouse can take advantage of this special rule for students. If you're unmarried, it's completely off the table.

Example 2: You work full-time and earn a $75,000 salary. Your wife is a full-time student for all or part of nine months and has no actual earned income. You have two children under 13 and $10,000 of childcare expenses for the time your wife goes to school. Under the special rule for students, she is deemed to have $4,500 of imaginary earned income ($500 x nine months). Your credit is $900 (20% x $4,500 expense cap based on your wife's $4,500 of imaginary earned income).

Important Point: The credit rules I've just explained apply for 2010. Less-generous rules are scheduled to take effect next year. However, I think Congress will extend the current more-generous provisions through at least 2011.

Child-Care FSA

Many companies have FSA plans that reimburse employees for expenses to care for children under 13. To receive tax-free reimbursements, the expenses must be necessary for you to work. If you're a married joint-filer, the expenses must be necessary for both you and your spouse to work (or for one to work while the other attends school full-time for at least five months).

Money to fund the FSA is withheld from your paychecks and is free of federal income, Social Security and Medicare taxes, as long as it's used to cover eligible childcare expenses. So this arrangement allows you to pay expenses with pretax dollars, which puts extra cash in your pocket. The maximum annual contribution is $5,000. If you're married and file jointly, the $5,000 cap represents a combined maximum for both you and your spouse. Beware: Please don't contribute more than you know you'll use, because any leftover FSA balance goes back to your employer.

You can't take advantage of both the credit and the tax-free FSA deal for the same childcare expenses, and any tax-free FSA reimbursements reduce your $3,000 or $6,000 expense cap for claiming the credit. Note that if you're in the 25% federal tax bracket or higher, the FSA option almost always saves more taxes than the credit. That's because the FSA allows you to avoid federal income tax (at least 25%) as well as Social Security and Medicare taxes (usually 7.65%), whereas the tax savings from the credit will usually be only 20%.

The Last Word

To claim the childcare credit or benefit from tax-free childcare FSA reimbursements, you must include Form 2441 (Child and Dependent Care Expenses) with your Form 1040. Keep that in mind at tax return time.

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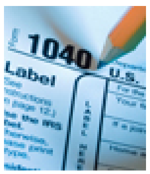

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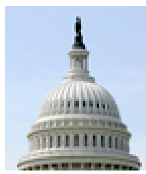

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