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CHILDREN

EXEMPTIONS, CREDITS AND INCOME SHIFTING TECHNIQUES

CHILDREN: Exemptions, Credits And Income Shifting Techniques

Children invariably mean making additional, often significant, expenses. However, the Tax Code provides many breaks in the form of exemptions, tax and childcare credits. There is also a credit for adoption expenses.

This guide highlights some important child tax breaks that may benefit you and your family and, in conjunction with your tax advisor, gives you some suggested strategies for tax planning.

DEPENDENCY EXEMPTION

In addition to the personal exemption that a taxpayer may take for himself or herself, an individual taxpayer may take a dependency exemption deduction for each individual who qualifies as a dependent. Each dependency exemption reduces taxable income. For 2010, the dependency exemption amount is \$3,650 per dependent. While the amount is subject to upward inflation indexing each year, the \$3,650 also applied to 2009 due to zero inflation between these years for purposes of this calculation. However, Congress decided to eliminate this decrease, effective for the 2010 tax year.



A dependent is characterized as either the taxpayer's qualifying child or qualifying relative. For purposes of the dependency exemption, your children include your:

- Natural children;
- Step-children;
- Step-siblings;
- Half-siblings;
- Adopted children;
- Eligible foster children;
- Descendent(s) of your child (i.e. grandchildren); and
- Descendent(s) of your siblings (i.e. nieces and nephews).

- **Planning Tip.** You can still claim an exemption for a dependent even if your dependent files a tax return.

Caution. If you can claim your child as a dependent on your return, your child may not claim his or her own personal exemption on his or her return.

Caution. No dependency exemption is allowed for your child unless you include the child's Taxpayer Identification Number (TIN) on your return.

Qualifying as a dependent

In general, certain tests must be satisfied before an exemption for a dependent is allowed. Some exceptions, however, apply to the general rules, and you should consult with your tax advisor if you have a unique situation. Generally, however, the following four tests must be met to claim a dependency exemption for a qualifying child:

(1) **Relationship.** A qualifying child, as mentioned above, must be your natural, step, half, adopted, or eligible foster child, or a descendent of any of them. A qualifying child may also be your brother, half-sister, stepbrother, stepsister, or a descendent of any of them.

Example. Aaron's household includes his son, Barry, his son's daughter, Connie, his sister, Danielle, and his nephew, Eduardo. All of these people satisfy the relationship test. Barry is Aaron's son; Connie is his grandchild; Danielle is his sibling; and Eduardo is a descendent of his sibling.

(2) **Age.** Generally, an individual must be under age 19, or a full-time student under age 24, to be treated as a child for purposes of

the dependency exemption. There is no age test for people who are permanently and totally disabled.

- (3) **Residence.** This test asks where does the child live? To qualify, a child must live with you for more than half of the year (except in the case of certain divorce or separation agreements).
- (4) **Citizenship.** The child must be a citizen of the U.S., U.S. resident alien, U.S. national, or a resident of Canada or Mexico.

Comment. A child who is away at school or college (or for a summer job) is treated as living with you for that time if he or she returns to your home at other times.

While the definition of a "child" is now uniform, the age for which a child qualifies for certain tax benefits is not:

- Child and dependent care credit — under age 13;
- Child tax credit — under age 17;
- Kiddie tax — children under age 19; students under age 24; and
- Dependents — usually under age 19.

Children of divorced or separated parents. In most cases, because of the residency test, a child of divorced or separated parents is the qualifying child

of the custodial parent. The custodial parent is the parent with whom the child lived for the greater part of the year. However, simply because you have custody of a child does not necessarily mean that you can automatically claim him or her as a dependent. The rules for divorced or separated parents can be complicated and you should discuss your situation with a tax professional.

Comment. If you have the right to claim your child (or children) as dependents, you can relinquish your exemption to your ex-spouse. Consult a tax professional before doing so.

Comment. The special rules that apply to children of divorced or separated parents also apply to children of parents who never married.

Adoption

A legally adopted child or a child placed in your home for adoption by an authorized agency is considered to be your child by blood.

If you are in the process of a domestic adoption, have custody of the child pending the final adoption, and provide enough financial support during the year, you may claim a dependency exemption for the child.

Caution. If you are adopting a child and do not have a TIN for the child, you must apply for an adoption taxpayer identification number (ATIN). An ATIN is a temporary



TIN assigned by the IRS. When the adoption becomes final, you must apply for a Social Security number (SSN) for the child. When assigned, the SSN, rather than the ATIN, is used as the child's TIN.

Exemption phaseout

The dependency exemption (\$3,650 per dependent for 2009 and, again, for 2010) may be reduced or eliminated depending on your income. For 2009 returns filed in 2010, the exemption phaseout begins at \$168,000 of adjusted gross income (AGI) for single individuals and at \$250,200 AGI for married persons filing joint returns. However, a taxpayer cannot lose more than one-third of the amount of his or her exemptions (that is, each exemption cannot be reduced to less than \$2,433). For 2010 returns filed in 2011, there is no reduction. The exemption amount is not subject to phase out for 2010.

CHILD TAX CREDIT

If you have a child under the age of 17 at the end of the tax year, you may be

entitled to a \$1,000 child tax credit for that year. You can claim a child tax credit for each qualifying child. As a credit, the child tax credit reduces your taxable income dollar-for-dollar and as such, is considerably more valuable than a tax deduction.

Comment. The \$1,000 per child amount is effective through 2010. After 2010, however, the credit is scheduled to fall to \$500 unless Congress extends it.

For low-income taxpayers without enough tax liability to cover the \$1,000 per child credit, a portion of the credit is refundable.

Refundable credit. For low-income taxpayers, the *American Recovery and Reinvestment Act of 2009 (2009 Recovery Act)* enhanced the child tax credit through 2010. If the total amount of a taxpayer's allowable child tax credit exceeds the taxpayer's total tax liability (regular and alternative minimum tax liability) the taxpayer is eligible for a refundable child credit equal to 15 percent of his or her earned income exceeding \$3,000.

Higher-income taxpayers, however, may be excluded from the benefit because the credit phases out as income rises.

Income phaseout

For 2010 (as had been the case in 2009), the child tax credit begins to phase out

when modified adjusted gross income (AGI) reaches:

- \$110,000 for married couples filing jointly;
- \$75,000 for single taxpayers; and
- \$55,000 for a married taxpayer filing separately.

The phase-out works by reducing the credit by \$50 for every \$1,000 of modified AGI above the thresholds.

Comment. The child tax credit amounts are not indexed for inflation.

Who qualifies?

The new definition uses the same relationship test that the dependency exemption uses. A qualifying child for the child tax credit is your:

- Natural child;
- Stepchild;
- Adopted child; or
- Eligible foster child.

A qualifying child can also be a descendent of your child or your sibling or a descendent of your sibling. Step-siblings and their descendents also qualify.

In addition, the qualifying child must be either a U.S. citizen, national, or resident of the United States.

Amount of credit

The child tax credit is \$1,000 per qualifying child, effective through 2010.

Caution. The age cut-off for the child tax credit is lower than for the dependency exemption. A qualifying child for the child tax credit must be under age 17.

CHILD AND DEPENDENT CARE CREDIT

Although you generally cannot deduct what you pay for child care as a direct deduction, you may be eligible to claim a portion of it as a tax credit if it enables you or your spouse to be gainfully employed. That credit, called the child and dependent care tax credit, is limited not only to amounts spent to be gainfully employed, but also by ceiling amounts and income tax bracket levels.

Comment. Do not confuse the child and dependent care credit with the child tax credit. They are two different credits.

If you pay someone to care for your child under the age of 13 so that you can work, you may be eligible for the child and dependent care credit (sometimes referred to as the childcare tax credit). You must be eligible to claim a dependency exemption for the child in order to claim the child and dependent care credit. The maximum credit is \$1,050 if one child is cared for and \$2,100 if care is provided for two or more children.



Caution. Any employer-provided dependent care benefits you receive that are excluded from your income reduce your qualifying expenses and the credit on a dollar-for-dollar basis.

You must also include the taxpayer identification number of each qualifying child on your tax return. You must also identify the care provider on your return as well.

Qualifying care. The care must be provided so that you – and your spouse, if married – can work or look for work. Thus, expenses can qualify for the credit only if they are employment-related expenses – those that enable you and your spouse to work.

If one parent works at home, no babysitting or other child care costs are eligible for the credit. If the stay-at-home parent goes to work part-time, however, child-care costs that enable the parent to work part-time are eligible.

Out-of-home care

A restriction applies to employment-related expenses that are incurred for services outside your household. These expenses count toward the credit only if incurred for the care of:

- A dependent who is under the age of 13 and for whom you are entitled to a dependency exemption; or
- Any other qualifying individual who regularly spends at least eight hours each day in the taxpayer's household.

Because of this rule, a portion of the cost of sending a child to boarding school can qualify as an employment-related expense. The costs of sending a child to an overnight camp, however, are specifically classified as not employment-related expenses and therefore are ineligible.

Other qualifying expenses include:

- Expenses for a child in nursery school, pre-school, or similar programs for children below the level of kindergarten;
- Expenses for before- or after-school care of a child in kindergarten or a higher grade may be for the care of a qualifying individual;
- The cost of a day camp or similar program; and
- Portions of the cost of sending a child to boarding school, such as

room, board and supervision after school hours, but not tuition.

Nonqualifying expenses. Expenses for a child in kindergarten or a higher grade are not for the care of a qualifying individual. Expenses for overnight camps are not employment-related expenses.

Nonqualifying caregivers. The payments for child care cannot be made to your spouse, someone you can claim as a dependent on your return, or to your child who is under the age of 19, even if he or she is not your dependent.

Caution. If you pay someone to come to your home and care for a dependent child or spouse, you may be a household employer for employment tax purposes. As a household employer, you may have to withhold and pay social security and Medicare tax (FICA) and federal unemployment tax (FUTA) for your employee. The rules can be tricky so consult with a tax professional to understand what your tax obligations may be.

Credit amount

The amount of the credit is based on a percentage of the employment-related expenses you incur during the tax year. The credit equals 20–35 percent of eligible expenses for individuals with adjusted gross income (AGI) of \$15,000 or less. The percentage decreases by one percent for each additional \$2,000 of AGI until it becomes

a flat 20 percent for individuals with AGIs of more than \$43,000.

Eligible expenses cannot exceed \$3,000 for one child or \$6,000 for two or more children.

Employer-provided assistance

If your employer provides child or dependent care, you may be eligible for some special tax incentives.

Up to \$5,000 of dependent-care assistance that you receive from an employer-paid child care program is completely tax-free.

If your employer maintains a cafeteria plan that lets employees choose between receiving fixed amounts of cash or qualified tax-free benefits, the amount you elect to receive for childcare assistance under the plan is tax-free if it doesn't exceed \$5,000.

Your employer may maintain a flexible spending account (FSA) that allows you to set aside part of your earnings in an account for childcare expenses. You use pre-tax dollars for child-care expenses.

Example. You and your spouse have two children who attend day care. If you contribute \$5,000 to an FSA and are in the 28 percent tax bracket, you will save \$1,400 ($\$5,000 \times 28$ percent) in tax. Furthermore, you get an additional tax savings of \$383 ($\$5,000 \times 7.65$ percent) because you don't have to pay the 7.65 percent Social Security tax on amounts contributed to an FSA.



ADOPTION CREDIT

Over the past 20 years, Congress has added very generous tax incentives for people who adopt children. If you adopt a “special needs” child, you are eligible for enhanced tax breaks.

Credit amount

You may claim a tax credit of up to \$10,000 (plus an annual inflation factor) for qualified adoption expenses. For 2009 returns filed in 2010, you may claim an inflation-adjusted credit of \$12,150. In 2010, you may claim a credit of \$12,170.

Qualifying expenses

Qualifying expenses include reasonable and necessary adoption fees, attorney fees, court costs, traveling expenses (including amounts spent for meals and lodging while away from home), and other expenses directly related to and for which the principal purpose is the legal adoption of an eligible child.

Eligibility. An eligible child must be under 18 years old, or be physically or mentally incapable of caring for himself.

Income phaseouts

The credit is not affected by your marital status and applies to each adoption. However, adjusted gross income (AGI) limits apply. For 2010, the credit phases out for all taxpayers, regardless of filing status, with AGI between \$182,520 and \$222,520. For 2009 returns, the amounts are \$182,180 and \$222,180, respectively.

If you adopt a special needs child in 2009 you may also claim up to a \$12,170 credit, even if your actual expenses are less than that amount. Special rules may apply to foreign adoptions.

AMT. You may claim the adoption credit against your regular and alternative minimum tax (AMT) liability. Although your credit may not reduce your regular and AMT liability below zero, you can carry forward any unused credit for up to five years.

Kiddie tax

Income-shifting has traditionally been one of several methods families use to lower their tax liability. One technique often used was to transfer highly appreciated property, like investment income, to children in order to take advantage of their lower tax rate.

However, Congress continues to lessen the effectiveness of this technique by ensnaring more and more children by the “kiddie tax.”

The “kiddie tax” is designed to lessen the effectiveness of intra-family transfers by parents to their children by taxing the unearned income of the child at their parents’ higher marginal tax rates.

In general, when a child has unearned income that exceeds a certain amount, the kiddie tax may be applied to that income at the parents’ rate, instead of the child’s.

Unless the parent(s) of a child under the age of 19 (24 if the child is a full-time student) makes a special election to include the child’s unearned income on the parent’s return, the child’s unearned income is taxed to the child at his or her parents’ top marginal rate on a separate return filed by the child (on his or her behalf, if a minor). A child who is over 19 but under 24 and a full-time student may be taxed at his tax rate if his earned income exceeds half of his total support for the tax year.

For 2010, a child’s unearned income in excess of \$1,950 is taxed at his or her parents’ top marginal tax rate. The first \$950 of a child’s unearned income (investment income, typically) is tax-free. The next \$950 is taxed at the child’s

own tax rate. But any net unearned income exceeding \$1,950 in 2010 of a child under the age of 19 (and under the age of 24 if a full-time student) is taxed at his or her parents' top marginal tax rate.

Comment. A child born on January 1, 1992 is considered to be age 19 at the end of 2010. A child born on January 1, 1987 is considered to be age 24 at the end of 2010.

Net unearned income equals unearned income, less the sum of:

- (1) \$950 for 2010; and
- (2) The greater of \$950 for 2010, or the amount of allowable deductions directly connected with the production of unearned income.

The recent increase in the age limit of children subject to the kiddie tax, from 18 to 24 for most college students, makes planning more complicated. The new kiddie tax rules effectively make the benefits of transferring high-income producing property to children to pay for college at lower tax rates a thing of the past.

While securities and other capital assets can be transferred annually to a child with no gift tax consequences if fair market value is not greater than \$13,000 (\$26,000 if a split-gift with a spouse is made), the kiddie tax rules



still trap the appreciation and gains at the parents' marginal tax rate if they exceed \$1,950.

A possible strategy to avoid the kiddie tax is to spread your child's gains over multiple years to avoid triggering the \$1,950 investment income threshold. However, this technique requires considerable planning. You should consult a tax planning professional about this strategy, and any other involving transfers of property or cash to your children, in order to avoid negative consequences and to maximize tax benefits.

Caution. If a child realizes net losses on the sale of securities there is no reverse kiddie tax. The parents can not use the loss to offset their own gains.

Put the kids to work

If you operate your own business, you may want to hire your children. Earned income is not subject to the kiddie tax, so you can shift funds to family members

in lower tax brackets, take advantage of your child's standard deductions and get work done in the process. If the compensation is reasonable, you may deduct it as a business expense.

CONCLUSION

The first step to taking full advantage of the child tax incentives is to understand their eligibility requirements. Your tax advisor will help you understand the definitions and complex terminology.

Once you've determined if you're eligible for a child tax credit or deduction,

you need to understand the mechanics of the tax incentive so you can maximize its value. Some credits and deductions are adjusted for inflation. Others have important income phase-out limitations.

Your tax advisor can start work today on a tax strategy using all or some of the child tax incentives. Talk to him or her and don't lose out on valuable child tax breaks.