CHILDREN

EXEMPTIONS, CREDITS AND INCOME SHIFTING TECHNIQUES

Wolters Kluwer

CHILDREN: Exemptions, Credits And Income Shifting Techniques

Children invariably mean you will need to incur additional, often significant, expenses. However, the Federal 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 2013, the dependency exemption amount is $3,900 per dependent. For 2014, the exemption amount increases to $3,950 per dependent. The amount is subject to upward inflation indexing each 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;
- Siblings;
- Step-children;
- Step-siblings;
- Half-siblings;
- Adopted children;
- Eligible foster children;
- Descendant(s) of your child (i.e. grandchildren); and
- Descendant(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. Special rules apply if a married dependent files a joint return.

Caution. If you can claim your child as a dependent on your return, your child cannot 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 social security number or taxpayer identification number (TIN) on your return.

Qualifying as a dependent

The following tests generally must be met to claim a dependency exemption for a qualifying child (some exceptions apply, however; consult with your tax advisor if you have a unique situation):

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

(2) ***Age.*** Generally, an individual must be younger than you (or younger than your spouse, if filing jointly), and must be either under age 19 or a full-time student under age 24, to be treated as qualifying child. There is no age test for children 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).

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.

(4) ***Citizenship.*** The child must be a U.S. citizen, resident alien, or national, or a resident of Canada or Mexico.

(5) ***Support.*** The child must not have provided more than half of his or her own support for the year.

Comment. A child who does not meet the qualifying child rules might instead be a dependent if he or she meets the requirements for a qualifying relative. Consult your tax advisor for more details.

While the definition of a "child" is now uniform, the age for which a child qualifies for certain tax benefits is not. Benefits with different age qualifications include:

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

- Health plan coverage – dependents under age 26; and
- Dependents — usually under age 19, students under age 24.

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 dependent(s), you can give up your dependency exemption to your ex-spouse. Consult a tax professional before doing so. A waiver also affects the availability of the Child Tax Credit and the Higher Education Credit.

> **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, for dependency exemption purposes.

> **Caution.** If you are adopting a child and do not have a social security number for the child, you must get an adoption taxpayer identification number (ATIN) for the child from the IRS. Consult your tax advisor for details on how to apply for an ATIN.

Income phaseouts

For 2013, the personal and dependency exemptions begin to phase out when adjusted gross income (AGI) reaches:

- $300,000 for married couples filing jointly or for surviving spouses ($305,050 for 2014);
- $275,000 for heads of household ($279,650 for 2014);
- $250,000 for single taxpayers ($254,200 for 2014); and
- $150,000 for a married taxpayer filing separately ($152,525 for 2014).

The phaseout reduces the exemptions by two percent for each $2,500 or fraction thereof ($1,250 if you are married filing separately) of AGI above the thresholds.

CHILD TAX CREDIT

If you have a child who is under age 17 at the end of the 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, this incentive reduces your taxable income dollar-for-dollar and as such, is considerably more valuable than a tax deduction.

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

Refundable credit. 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 of up to 15 percent of his or her earned income exceeding $3,000.

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

Income phaseout

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 phaseout reduces 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?

A qualifying child for the child tax credit must be the taxpayer's qualifying child for purposes of the dependency exemption. A qualifying child is your:

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

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

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

> ***Caution.*** A qualifying child for the child tax credit must be under age 17, which is *lower* than the cut-off age for claiming the dependency exemption.

CHILD AND DEPENDENT CARE CREDIT

Although you generally cannot deduct what you pay for child care as a direct tax 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 or to look for a job. That credit, called the child and dependent care tax credit, is limited not only to amounts spent on qualifying expenses, but also by ceiling amounts and income 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 or look for work, you may be eligible for the child and dependent care credit (sometimes referred to as the "child care tax credit," but not to be confused with the child 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 amount of eligible expenses that can be claimed for the credit is $3,000 for one qualifying child, $6,000 for two or more qualifying children.

> **Caution.** Any employer-provided dependent care benefits you receive that you exclude or deduct from your income must reduce the maximum credit amount on a dollar-for-dollar basis.

> **Caution.** To claim the credit, you (and your spouse if filing jointly) *must* have earned income during the year.

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

> **Comment.** The credit is also available if you pay someone to care for certain dependents who are physically or mentally incapable of caring for themselves. Consult your tax advisor for more information.

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 work-related.

If one parent stays at home and is not employed, no babysitting or other child care costs are eligible for the credit. If the stay-at-home parent goes to work part-time, however, childcare costs that enable the parent to work part-time are eligible.

Out-of-home care

A restriction applies to work-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 age 13; or
- Any other qualifying individual who regularly spends at least eight hours each day in the taxpayer's home.

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

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 to attend kindergarten or a higher grade are not for the care of a qualifying individual. Expenses for overnight camps are not work-related expenses. Summer school and tutoring programs are not for care.

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 child and dependent care credit is based on a percentage of the work-related expenses you incur during the year. The maximum credit equals 35 percent of eligible expenses for individuals with adjusted gross income (AGI) of $15,000 or less. The percentage decreases by one percentage point 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. The credit is nonrefundable: it cannot be taken to the extent it exceeds what would otherwise be your tax liability.

Caution. If you are married, you *must* file a joint return with your spouse in order to claim the child and dependent care credit, unless you are legally separated or you lived apart from your spouse during the last six months of the year.

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 (up to $2,500 if married filing separately).

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 does not 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 x 28 percent) in tax. Furthermore, you get an additional tax savings of $383 ($5,000 x 7.65 percent) because you don't have to pay the 7.65 percent social security tax on amounts contributed to an FSA.

Caution. If you received dependent care benefits that you exclude or deduct from your income, you must *subtract* that amount from the $3,000 or $6,000 limit that applies to you for the child and dependent care credit.

ADOPTION CREDIT

The Federal Tax Code provides 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

Taxpayers who incur qualified adoption expenses may be eligible for an adoption credit or, in the case of employer-provided assistance, an exclusion from income. The adoption credit and exclusion amount is adjusted annually for inflation. For 2013, the credit or exclusion amount is $12,970. For 2014, the amount increases to $13,190.

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.

Eligible child

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

If you adopt an eligible child with special needs, you may be able to take the adoption credit and exclusion even if you or your employer *did not* pay any qualified expenses. An eligible child has special needs if the child is a U.S citizen or resident whom a state has determined:

- cannot or should not be returned to his or her parents' home, *and*
- will not be adopted unless the adoptive parents receive assistance, due to factors such as the child's ethnic background, age, minority or sibling group, medical condition, or physical, mental, or emotional handicap.

Income phaseouts

The adoption credit is not affected by your marital status and applies to each adoption. However, adjusted gross income (AGI) limits apply. Both the credit and exclusion amounts phase out ratably when a taxpayer's modified AGI exceeds certain thresholds that are adjusted annually for inflation. For 2013, the credit and exclusion begin to phase out at modified AGI over $194,580, and phase out completely at modified AGI of $234,580 or more. For 2014, the phaseout range is $197,880-$237,880.

AMT. You may claim the adoption credit against your regular and alternative minimum tax (AMT) liability. Although your credit cannot 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 has lessened the tax effectiveness of intra-family transfers from parents to their children by ensnaring more and more children with the "kiddie tax."

The "kiddie tax" is designed to lessen the effectiveness of tax-lowering transfers 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' tax rate, instead of the child's rate.

Unless the parent(s) of a child under age 19 (under age 24 if the child is a full-time student) makes a special election to include the child's interest and dividend income on the parent's return, the child's unearned income may be 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 age 18 (or over 18 but under 24 and a full-time student) may be taxed at his or her tax rate, not the parents' rate, if the child's earned income was more than half of his or her total support for the year.

For 2013 and 2014, the first $1,000 of income of a child subject to the kiddie tax will generally not be taxable, and

the next $1,000 will be taxable at the child's own bracket. Unearned income in excess of $2,000 will be taxed to the child at the parent's tax rate.

> ***Comment.*** A child is considered to have attained age 19 (or age 24) for purposes of escaping from the kiddie tax for 2014 if born anytime on or before January 1, 1996 (or January 1, 1991, to be under age 24 at the end of 2014).

> Comment. The IRS treats a child who turned 19 on January 1 as if he or she had been 19 during the previous tax year for purposes of the kiddie tax.

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

(1) $1,000 for 2013 (same for 2014); and
(2) The greater of $1,000 for 2013 (same for 2014), or the amount of allowable itemized deductions directly connected with the production of unearned income.

By pulling certain full-time students under age 24 within its rules, the kiddie tax has made tax planning more complicated. The kiddie tax effectively makes 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 $14,000 ($28,000 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 $2,000.

A possible strategy to avoid the kiddie tax is to spread your child's gains over multiple years to avoid triggering the $2,000 investment income threshold. However, this technique requires considerable planning. You should consult a tax planning professional about this strategy, and any other techniques 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 cannot 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 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 phaseout limitations.

Your tax advisor can start work today on a 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.

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