



October 3, 2017

## Regulations for Dependent Care Expenses

Dependent care regulations [part 1](#) and [part 2](#), effective August 14, 2007, regarding the dependent care tax credit are still relevant today. This is a refresher course of basics and clarifications issued by the Internal Revenue Service (IRS).

The dependent care credit is a nonrefundable tax break which is a percentage of eligible daycare expenses incurred in order for the taxpayer (and spouse, if married) to be gainfully employed. For incomes below \$15,000, the tax credit is 35 percent of eligible expenses, ratably decreased to 20 percent when the household income exceeds \$43,000.

Now is a good time to review the rules for the dependent care credit, dependent care flexible spending accounts (FSAs), and point out the clarifications contained within the guidance. Incorporated in this article are basic facts surrounding dependent care rules and limits, plus new interpretations contained in the proposed regulations. These regulations are specifically for the tax credit available under IRC Section 21, but shed a lot of light on eligible expenses for dependent care FSAs.

### Qualifying Person

Expenses must be incurred for a qualifying person, such as the taxpayer's dependent child who has not attained age 13. A qualifying person can also be the taxpayer's spouse, dependent, or qualifying relative provided they are physically or mentally incapable of self-care and have the same principal residence as the taxpayer for more than half the year.

If the child turns 13 during the year, the full credit may still be taken, but only for expenses incurred prior to them turning age 13. And if services are provided outside of a taxpayer's home, the dependent must spend at least eight hours per day in the taxpayer's home.

### Earned Income

Expenses qualifying for the credit may not exceed:

1. A single taxpayer's earned income for the taxable year; or
2. for a married taxpayer, the taxpayer's earned income or the spouse's earned income, whichever is less.

If the spouse is a full-time student or incapable of self-care, they are considered to have "deemed" earned income. The amount of "deemed" earned income is \$250 per month if the household contains one dependent and \$500 per month for two or more dependents.

A "full-time" student is an individual who is enrolled at and attends a school or educational institution during each of any five calendar months (need not be consecutive) of the taxable year. The definition of "school" includes technical, trade and mechanical schools, but does not include on-the-job training, correspondence or internet schooling. The number of credit hours taken must be considered to be a full-time course of study and cannot be taken exclusively at night.

"Deemed" earned income may be attributable to only one spouse. As a result, under certain circumstances, the credit may not be available to particular households. An example would be if one spouse is incapable of self-care and the other spouse is attending school full time. Taxpayers may, however, be able to include non-taxable combat pay as earned income.

### **Work-Related Expenses**

The taxpayer must be gainfully employed or actively seeking gainful employment in order to take advantage of this tax break. Employment can be inside or outside the house and includes self-employment. Work as a volunteer or for nominal consideration is not considered gainful employment.

Expenses for dependent daycare must be allocated on a daily basis. However, for administrative convenience, short or temporary absences from work may be disregarded. A minor illness or vacation is construed to be temporary for taxpayers who must pay dependent care expenses on a weekly basis. And each case is determined based on all the facts and circumstances. For instance, a four-month absence from work because of illness would not be considered short or temporary.

An example of this rule involves a part-time employee who works three days per week and pays their daycare provider on a weekly basis. Generally, part-time employees must allocate expenses for care between days worked and days not worked. However, if they are required to pay daycare expenses on a periodic basis like weekly or monthly, no allocation is necessary because the payment includes days worked and not worked.

In the above example, if the daycare provider charges on either a three-days-per-week or five-days-per-week scale, then this participant could not count the other 2 days because a fee structure is available for paying the daycare provider a three-day fee.

The IRS also reasoned that a day on which the taxpayer works at least 1 hour is a day of work.

- **Nursery school** expenses qualify for the dependent care credit, although some or all of the expenses may be educational.
- **Food, lodging and clothing** are generally not considered for the care of a qualified individual and therefore cannot be used toward the tax credit. However, if these expenses are incidental to and inseparably a part of the care of a qualifying individual, the entire amount of the expense is deemed to be for care.
- **Kindergarten** expenses are considered educational and not allowed as an expense for the tax credit. But expenses for care provided before and after school may be applied toward eligible expenses.
- **Day camp** expenses are acceptable for qualified individuals even if the camp specializes in a particular activity like music or soccer.
- **Overnight camp** is not considered work related. Expenses, even pro-rated, that are paid for an overnight camp may not be taken into account as eligible expenses for the tax credit.
- **Medical expenses** may not be regarded as daycare expenses. For example, the expenses incurred by a taxpayer may not be used as both medical and daycare expenses for tax return purposes.
- **Transportation** to a day camp or to an after-school program not on school premises and furnished by a dependent care provider may be eligible daycare expenses if all other applicable requirements are satisfied.

- Wages paid for **household services** may be applied toward the tax credit if their main responsibility is for the care and well-being of a qualified person. If the household services are partly for common household services and partly for the care of a qualified individual, the wages should be allocated appropriately for the daycare tax credit.
- Even the **employment taxes** paid on behalf of a household services person are considered eligible daycare expenses. However, you can't include payments for the services of a chauffeur, bartender or gardener – these amenities are not considered "household services."
- **Indirect expenses** eligible for the daycare credit may include the cost of a care provider's room and board, application and agency fees and deposits if the taxpayer is required to pay the expenses in order to obtain the care. However, forfeited deposits and other payments are not considered for the care of a qualifying individual if the care is not actually provided.
- Although **boarding school** is generally not an eligible daycare expense, an order to report for duty in the Armed Forces may make some boarding school expenses suitable for the tax credit. The expenses must be allocated between care, education and other services not constituting care.
- **Payments to relatives.** Payments to either the taxpayer's spouse or to a parent of the taxpayer's child who is not the taxpayer's spouse do not qualify for the credit. Payments to an individual for whom a deduction on the tax return can be taken or their child under the age of 19 at the close of the taxable year also do not constitute eligible expenses.
- The tax credit may only be claimed by the **custodial parent**. In other words, only one parent may claim the credit. Although the child may reside with the "non-custodial" parent during the summer and eligible daycare expenses are incurred, the non-custodial parent cannot take the credit for that period of time. This is true even if the non-custodial parent claims the dependency exemption for that child, but the child does not share the same principal residence for the greater portion of the calendar year.

## Joint Return Requirement and Dollar Limits

### Dependent Care FSAs

Current limits for Dependent Care FSAs fall under the jurisdiction of IRC Section 129. A participant may redirect \$5,000 for any taxable year if a joint return is filed with a spouse, or for singles that file as "Head of Household." A \$2,500 limit applies for those who are married and file separate returns. These dollar limits were initiated by adding IRC Section 129 in 1981, have never been increased, and are used regardless of the number of qualifying dependents.

One more thing – the available tax credit is reduced dollar for dollar by the amount of payments received from the dependent care FSA.

### Dependent Care Expense Limits for the Tax Credit

The dollar limits for the tax credit are based on the number of dependents in the household. They are \$3,000 for one qualifying dependent and \$6,000 for two or more qualifying dependents.

However, expenses do not have to be equally divided between the two or more dependents. These regulations add an interesting clarification that a taxpayer may apply the limitation for

two or more qualifying individuals in unequal proportions. For example, eligible expenses would include those incurred in the amount of \$4,000 for one dependent and \$2,000 for the remaining dependent.

### Provider Identification

Taxpayers must fill out Form 2441 or Schedule 2 and attach to their Form 1040 or 1040A in order to take the credit or if they participate in an employer's dependent care assistance plan, and taxpayers are warned to maintain adequate records to support the expenses claimed.

The daycare provider must be identified on Form 2441 or Schedule 2 at tax filing time. In order to receive the credit, the taxpayer must provide the name, address and taxpayer identification number of the daycare provider. Failure to procure this information may mean the expenses cannot be used either for the tax credit or dependent care FSA expenses.

Spare no expense! The IRS pointed out that daycare services selected by the taxpayer need not be the most inexpensive. However, we're looking at a maximum of expenses for the credit to be \$3,000 or \$6,000 – or \$5,000 through a cafeteria plan. So let's face it, how far is that going to go?

Also, check out [IRS Publication 503](#). It is a terrific resource for all the rules surrounding the tax credit and dependent care expenses.

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