

KIDS AND TAXES

So How Much are Kids Really Worth?

On average, it costs \$204,060 to raise a child to age 18¹ and \$16,357 to send one to college for a year²

RJ Goodman, EA
SOS Business Services
Presented to CSTC Foothill Chapter
July 10, 2008

Who Qualifies?³ It all depends . . .

Claiming a child as a dependent gives the parent a \$3,500 federal exemption⁴ deduction (2008 tax year figures) and a \$294 California exemption Credit⁵. (2007 tax year figures)

Federal exemption deduction phase out begins at (2008)	California exemption credit phase out begins at (2007)
\$159,950 - \$282,450 (Single)	\$155,416 (Single, MFS or RDP filing separately)
\$239,950 - \$362,450 (MFJ or QW)	\$233,129 (HH)
\$199,950 - \$322,450 (HH)	\$310,837 (MFJ (including RDPs) or QW)
\$119,975 - \$181,225 (MFS)	

Since the 2005 unified definition of a qualifying child we have two types of dependents: a qualifying child and a qualifying relative (a dependent who isn't a qualifying child).

All Dependents

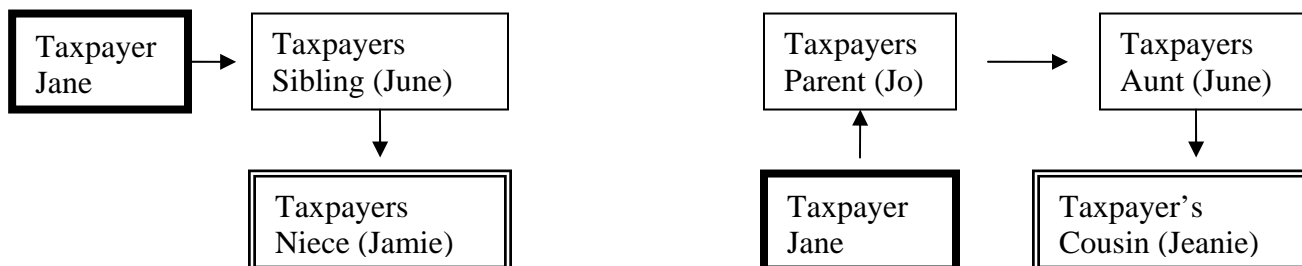
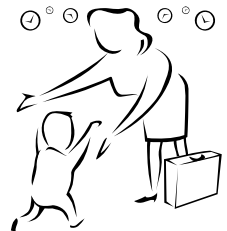


Three tests apply to *all* dependents, whether qualifying child or qualifying relative

- 1) Dependent taxpayer test (i.e. a dependent cannot claim dependents)
- 2) Joint Return Test (dependent cannot file a joint return unless the return is filed only for a refund and neither spouse has any tax liability jointly or separately)
- 3) Citizen or resident test (dependent must be a U.S citizen, resident alien or national¹, or must be a resident of Canada or Mexico for some part of the year).

Qualifying relative - Someone who isn't a qualifying child

- Meets the old gross income and support tests
 - Gross income must be less than the exemption amount
 - Taxpayer must have provided more than half of the dependents support (the exception for multiple support agreements still applies)
- Cannot be the qualifying child of another taxpayer (unless they're not required to file)
- Who either lived with the taxpayer all year, or was closely related enough to not be required to live with the taxpayer all year -- Two arrow test (descendency or ancestry counts as one arrow, a sibling relationship counts as one arrow). For example:
 - A niece (one arrow across (sibling) one arrow down (sibling's child) will qualify.
 - A cousin (one arrow up (to taxpayer's parent) one arrow across (from parent to the taxpayer's aunt or uncle), one arrow down (from the aunt or uncle to the cousin) is one arrow too many – they must live with the taxpayer all year to qualify.



¹ "A U.S. national is an individual who, although not a U.S. citizen, owes his or her allegiance to the United States. U.S. nationals include American Samoans, and Northern Mariana Islanders who chose to become U.S. nationals instead of U.S. citizens." From IRS pub 519.



Qualifying child

A foster child is a child placed with the taxpayer by an authorized placement agency or by order of the court

- The taxpayer’s descendent², sibling, or descendent of a sibling or *foster child*.
- Under 19 or under 24 and a full-time student, or disabled at any age (the old EIC age test)
- Lived with the taxpayer for more than half the year (see below)
- Not have provided over half of their own support (parents are **not** required to provide over half of the support anymore, as long as it isn’t the child making up the difference)
- Not the qualifying child of someone else, unless the taxpayer is the person entitled to claim them.



In general, the child must live with taxpayer for more than half the year, however, for divorced or separated parents a noncustodial parent can still have a qualifying child if certain conditions apply:

- Parents must have a decree of divorce, a written separation agreement, or have lived apart the last six months of the year
- The child received over half of their support from the parents
- One or both of the parents had custody of the child for over half the year
- Decree of divorce, separate maintenance, or written separation provides that noncustodial parent can claim the child as a dependent, or custodial parent signs a written declaration (from 8332) waiving the dependent.

	<h3 style="text-align: center;">Tie breaker rules for who claims the child</h3> <p>Only applies when all parties for whom the child is a qualifying child cannot agree on who claims the child. If two parties for whom the child is a qualifying child claim the child, the child will be awarded first to</p> <ol style="list-style-type: none"> 1. The child’s parent if only one claimant is a parent 2. The parent with whom the child lived the most if both claimants are parents 3. The claimant with the highest AGI if the child lived with both parents the same amount of time, or if neither claimant is a parent <p style="text-align: center;"><i>If they can’t agree, it’s determined by blood, then money</i></p>
--	---

Children and Filing Status

- \$ Children are required or helpful in claiming more advantageous filing statuses.
- \$ The taxpayer must have a dependent child living with them all year to file as qualifying widow.
- \$ To qualify as unmarried for tax purposes, a dependent child (or a child who would be a dependent if exemption wasn't waived to non-custodial parent) must have had its primary residence with the taxpayer.
- \$ For unmarried taxpayers, a child can be a qualifying person for head of household (although other relatives may qualify as well), increasing the standard deduction from \$5,450 to \$8,000.

² I use descendent to include any child – whether natural, adopted (or placed with the taxpayer for adoption), placed as a foster child by a state agency, or stepchild, as the IRS generally does not distinguish between them.
Also, relationships established by marriage (in-laws, step-children, half-siblings, etc) are treated the same as blood relationships, even after divorce or death (just not while the taxpayer is MFS)

A Quick Review of Filing Status Qualifications⁶

Married Filing Jointly - Taxpayer and spouse are married as of December 31 of the tax year and both desire to file a joint return. If the taxpayer or spouse died before the end of the tax year, they must have been married as of the date of death. The surviving spouse can still file jointly with the deceased if she or he has not remarried before the end of the tax year.

Married Filing Separate - taxpayer and spouse were married as of December 31 of the tax year, but do not wish to file jointly and do not qualify for or wish to use a more advantageous tax status. Many deductions and credits are reduced or completely unavailable to taxpayers whose filing status is Married Filing Separate.

Single - Unmarried or legally separated as of December 31 of the tax year, or qualify as unmarried for tax purposes.



Registered Domestic Partners file Married Filing Joint or Married Filing Separate in California, but Single on their federal return, unless they qualify for another filing status.

Qualifying Widow, Unmarried for Tax Purposes, and Head of Household Filing Statuses			
	Qualifying Widow(er)	Unmarried for Tax Purposes	Head of Household
All:	Must have paid more than half the actual cost of maintaining a home for a qualifying person		
Marital Status	Widowed	Married	Single or Unmarried for Tax Purposes
About the Spouse	Spouse passed away during the prior two years. The filing status is usually MFJ for the year the spouse passed away	Married, but spouse cannot have lived in the home at any time during the last six months of the year	
Qualifying people – generally must live with taxpayer for more than half the year unless an exception is noted	<i>Dependent child</i> who lived <i>the entire year</i> with the taxpayer	Dependent <i>child</i> (or child who would be dependent if exemption wasn't waived)	<input type="checkbox"/> A qualifying child (except the qualifying child of a noncustodial parent) <input type="checkbox"/> A dependent parent, whether or not they lived with the taxpayer <input type="checkbox"/> "Two Arrow" qualifying relative (unless dependency was awarded under a multiple support agreement)

Child Related Tax Benefits

*Child Tax Credit (Federal Only)*⁷

- Up to \$1,000 per child under age 17 (non-refundable)
- Subject to AGI Phase-out (begins at \$110,000 MFJ, \$75,000 Single, HH, QW, \$55,000 MFS)
- One of very few credits available to MFS taxpayers
- Child must be taxpayer's dependent

Refundable Additional Child Tax Credit

- Allowed up to amount of child tax credit not claimed due to liability limitations
- Available based on earned income
 - 2003 10% of earned income above \$10,750
 - 2004 15% of earned income above \$10,750
 - 2005 15% of earned income above \$11,000
 - 2006 15% of earned income above \$11,300
 - 2007 15% of earned income above \$11,750



Non taxable combat pay is included in earned income for this calculation

- Also available to the extent FICA taxes exceed EIC for taxpayers with three or more children.

<i>Child and Dependent Care Credit</i> ⁸							
Maximum: \$1,050/\$2,100 (two or more children)	CA maximum \$525/\$1,050 (two or more children)						
Form 2441 Federal Nonrefundable	Form 3506 \$\$\$Refundable \$\$\$						
Qualifying Person: <ul style="list-style-type: none"> <input checked="" type="checkbox"/> Dependent child under age 13 (including child of custodial parent who waived exemption other parent) <input checked="" type="checkbox"/> Disabled spouse (or RDP for California credit) who is unable to care for themselves <input checked="" type="checkbox"/> Any disabled persons who are unable to care for themselves who can be claimed as a dependent, or who qualifies as a dependent except for the gross income requirement, or who could be claimed as a dependent if the taxpayer (or spouse) weren't claimed on another return. 							
Qualified Expenses <ul style="list-style-type: none"> <input checked="" type="checkbox"/> As much as 35% of care expenses – up to \$3,000/\$6,000 if there are two or more qualifying persons <input checked="" type="checkbox"/> Household service expenses may be included if they are needed to care for the qualifying person <input checked="" type="checkbox"/> Expenses for care that allows the taxpayer to work or look for work. <input checked="" type="checkbox"/> Child care payments to spouses, dependents, nondependent children under 19, and the child's other parent do not qualify 	Allowed only for expenses of care provided in California. Percentage of calculated federal credit <table style="margin-left: auto; margin-right: 0;"> <tr> <td style="text-align: right;">\$0- \$40,000</td> <td style="text-align: left;">50%</td> </tr> <tr> <td style="text-align: right;">\$40,001-\$70,000</td> <td style="text-align: left;">43%</td> </tr> <tr> <td style="text-align: right;">\$70,001-\$100,000</td> <td style="text-align: left;">34%</td> </tr> </table>	\$0- \$40,000	50%	\$40,001-\$70,000	43%	\$70,001-\$100,000	34%
\$0- \$40,000	50%						
\$40,001-\$70,000	43%						
\$70,001-\$100,000	34%						
Required Information <ul style="list-style-type: none"> <input checked="" type="checkbox"/> Care providers Name, Address <input checked="" type="checkbox"/> SSN/EIN or Tax Exempt. Credit will generally be disallowed without identifying number, although taxpayer may still claim it if they can show due diligence	Providers Telephone Number is required <div style="border: 2px solid black; padding: 5px; margin-top: 10px;"> ● Care providers who work in the taxpayer's home are generally considered employees of the taxpayer </div>						

<p>Limited by Earned Income</p> <ul style="list-style-type: none"> <input checked="" type="checkbox"/> Credit is based on lesser of taxpayer's earned income, spouse's earned income, actual childcare expenses, and limitation above (disregard community property laws). <input checked="" type="checkbox"/> Combat pay is included by election only <input checked="" type="checkbox"/> \$250/\$500 (two or more children) earned Income credited to student or disabled spouse per month for this credit only <input checked="" type="checkbox"/> If the employer offers dependent care benefits, up to \$5,000 can be excluded from taxable income (allowed expenses for credit reduced by any excluded income) 	<p>Based on California Earned Income Includes:</p> <ul style="list-style-type: none"> <input checked="" type="checkbox"/> California source earned income (from wages, including combat pay or self-employment) <input checked="" type="checkbox"/> Strike benefits related to California Employment <input checked="" type="checkbox"/> Disability payments reported as California Wages <input checked="" type="checkbox"/> Active Duty military pay, regardless of domicile <input checked="" type="checkbox"/> Each month, one (but not both) spouses or RDPs can claim \$250/\$500 per month that they were a full time student (if in school for more than 5 months of the year) or disabled
No Federal AGI Phaseout, but percentage is reduced to 20% at higher incomes	Not allowed when AGI exceeds \$100,000
<p>Allowed to MFS taxpayers if they:</p> <ul style="list-style-type: none"> <input checked="" type="checkbox"/> Lived apart the last six months of the year <input checked="" type="checkbox"/> Had a qualifying person in their home for more than half the year <input checked="" type="checkbox"/> Paid more than one half the cost of keeping up a home 	

⊗ Prior to January 1 of 2005⁹, California offered a *long-term care credit* of up to \$500 for eligible caregivers of individuals (including children) in need of long-term care. This credit is available for

- Children under two who require durable medical equipment and the care of a skilled practitioner should the child's parents or guardian be absent.
- Children under six (but over two) who are unable to perform two or more of the following activities - eating, transferring and mobility.
- Children (and adults) over six who are unable to perform at least three activities of daily living (bathing, eating, continence, toileting, dressing, and transferring) without substantial assistance, or who require supervision to protect them from threats to health and safety due to their impairment.

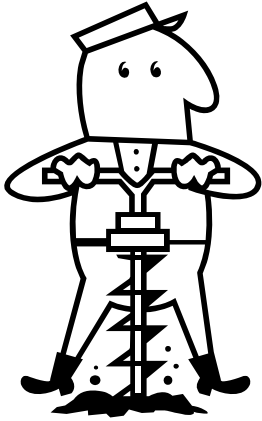
Earned Income Credit¹⁰ -- \$\$Refundable \$\$

Stats¹¹

Qualifying Children	None	1	2 or More
Maximum Credit	\$438	\$2,917	\$4,824
Maximum Credit at	\$5,720	\$8,580	\$12,060
Phase out begins (MFJ)	\$10,160	\$18,740	\$18,740
All Others	\$7,160	\$15,740	\$15,740
Phase out ends (MFJ)	\$15,880	\$36,995	\$41,646
All Others	\$12,800	\$33,995	\$38,646

Qualifications for all EIC recipients:

- Taxpayer (and spouse) must have a valid SSN (i.e. authorized to work in the United States) and be U.S. Citizens or Resident Aliens all year.
- Not available to Married Filing Separately Taxpayers
- Cannot exclude foreign earned income using form 2555
- Investment income must be less than **\$2,950** (interest, dividends, capital gains, royalties, rental and passive activities)
- Cannot be the qualifying child of another taxpayer



- Must have earned income to qualify, including:
 - Wages (including statutory employees), salaries, tips
 - Net Self-employment income (Generally SE income less ½ of SE tax)
 - Strike pay
 - Disability pensions until the taxpayer reaches minimum retirement age
 - Nontaxable combat pay is *excluded* unless the taxpayer elects to include it.
 - For taxpayers who have opted out of Social Security and Medicare (Using form 4361 for ministers and form 4029 for conscientious objectors because of religious beliefs), self-employment income is excluded, but wages are not.
- Items excluded from earned income
 - ☛ Earnings while an inmate
 - ☛ Workfare payments
 - ☛ Spouse's earned income reported under community property laws
 - ☛ Scholarships or fellowships not reported on a W2

Qualifying children – this should look familiar. A qualifying child must:

- Be the taxpayer's descendent, sibling, or descendent of a sibling
- Be under 19 or under 24 and a full-time student, or disabled
- Have lived with the taxpayer for more than half the year in the United States (military personnel stationed outside the US on extended active duty are considered to have lived in the U.S.)
- Have a valid SSN (unless they were born and died in the same year)
- Not be the qualifying child of someone else (see the tiebreaker rules under qualifying child)
- Taxpayer must be able to claim exemptions for married children

If there are no Qualifying Children there are additional requirements for the taxpayer:

- Must be between the ages of 25 and 65
- Cannot be a dependent or qualifying child of another taxpayer
- ☛ If the taxpayer has been disallowed from claiming EIC since 1996, they must complete and attach form 8862 to their return.
- ☛ Taxpayers found to have claimed EIC incorrectly due to reckless disregard for EIC rules are prohibited from claiming EIC for *two* years
- ☛ Taxpayers found to have fraudulently claimed EIC are prohibited from claiming EIC for **ten** years.
- ☛ Special Due Diligence requirements for tax preparers: (\$100 penalty per failure) IRS determines whether to assess preparer or employer
 - √ Complete form 8867 (paid preparer's checklist)
 - √ Complete the appropriate EIC worksheet
 - √ Must not know or have reason to believe that any information relating to EIC is incorrect
 - √ Retain records for three years, including record of how information was obtained

The good news is that your software likely does all of this (except the records retention) for you – although, to quote the IRS “We realize that most of you use software to prepare tax returns which contains interview questions that feed to the Form 8867, however be sure these interview questions cover all of the questions on the form 8867 and you ask all of the appropriate questions¹².”

According to a recent IRS presentation on the earned income credit, having the client sign the 8867 will *not* relieve you of your due diligence requirements

Adoption Credit¹³



Form 8839 Federal – Nonrefundable	CA Credit Code 197 ¹⁴ - Nonrefundable
Up to \$11,650 per child based on expenses of adopting a child	Up to 50% of expenses of adopting a child up to \$2,500 per child.
For adoptions of special needs children, credit is the maximum amount, even if parent’s had no adoption costs ¹⁵ . Special needs status is determined by the state, but must be U.S. citizens or residents when the adoption process began.	
Qualified Child <input checked="" type="checkbox"/> Child under the age of 18 <input checked="" type="checkbox"/> Disabled child of any age if they are unable to care for themselves	Qualified Child <input checked="" type="checkbox"/> U.S citizen or resident <input checked="" type="checkbox"/> In the custody of a CA public agency or political subdivision
Qualified Expenses <input checked="" type="checkbox"/> Expenses incurred in the prior year for the uncompleted adoption of a U.S. Citizen <input checked="" type="checkbox"/> Expenses incurred in the current year for a completed adoption <input checked="" type="checkbox"/> Prior years expenses incurred after 1996 in the year of completion for adoption of a non U.S. citizen <input checked="" type="checkbox"/> Reasonable and necessary expenses directly related to and for the principle purpose of the legal adoption of an eligible child <input checked="" type="checkbox"/> Expenses of adopting a spouse’s child are excluded, as are expenses allowed as a credit or deduction elsewhere, and surrogacy expenses.	Qualified Expenses <input checked="" type="checkbox"/> Claimed in the year the adoption is final. <input checked="" type="checkbox"/> Adoption agency fees, medical expenses and travel for the adoptive family only. <input checked="" type="checkbox"/> Any deduction for these expenses must be reduced by any credit taken <input checked="" type="checkbox"/> Costs of unsuccessful attempt to adopt one child are added to costs of subsequent successful attempt to adopt another child.
<input checked="" type="checkbox"/> If the employer offers adoption assistance benefits, up to \$11,650 can be excluded from taxable income (allowed expenses for credit are reduced by any excluded income) <input checked="" type="checkbox"/> For a special needs child, \$11,650 is excluded from income if employer benefits were provided, regardless of the amount of benefits. <input checked="" type="checkbox"/> If two people adopted one child, they can divide the exclusion between them in any way both agree	
AGI Phaseout: Modified AGI must be under \$214,730	
May be taken by MFS taxpayers if 1) Lived apart from spouse last six months of the year 2) Eligible child lived in taxpayer’s home over six months of the year 3) Taxpayer paid more than half the cost of maintaining a home	
Five year carryover provisions.	Carryover provisions.

California Credit for Senior Head of Household Code 163

Credit for qualifying taxpayers who become unable to file head of household in the two years following the death of the qualifying person.

- Available to taxpayers 65 or older whose qualifying person for head of household died during the one of the preceding two years (2005 or 2006 for 2007 tax year)
- Credit is lost when AGI exceeds \$60,791
- 2% of taxable income up to \$1,146

California Credit for Joint Custody Head of Household Code 170

Consolation prize for the half of joint custody that doesn't have the child enough to file head of household.

- Not available to taxpayers who can use the Head of Household or Qualifying Widow/er status
- Taxpayer must be able to claim the exemption of a married child
- Taxpayer must be unmarried, or not have lived with spouse or RDP the last six months of the year, and paid more than half of the cost of maintaining a home that was the main home of the child for at least 146 days but no more than 219 days per year.
- Cannot be claimed with the Credit for Dependent Parent (a similarly calculated credit for MFS/RDPS taxpayers who paid more than half the cost of a parent's home)
- Credit is 30% of tax up to \$374¹⁶

Education tax Benefits (federal only)¹⁷



Scholarships

- Scholarships used for tuition, fees, books, supplies, and equipment that are required for attendance at an eligible educational institution. Scholarships that are used to pay tuition and fees reduce qualified expenses for other educational tax breaks, so when possible, apply the scholarship to books, supplies, and equipment first. (This also works with Coverdell ESA & QTP distributions)
- Scholarships for room and board are taxable, as are most scholarships and fellowships that are payment for services (Enter SCH next to line 7 if no W2 was received).
- Payments for education, training, or subsistence from the Department of Veteran Affairs are tax free
- Student must be a candidate for a degree (includes a program of training to prepare students for a recognized occupation)
- Eligible institution is one that maintains a regular faculty, curriculum, and enrolled student body

Hope Credits (per student)

- 100% of the first \$1,200 and 50% of the second \$1,200 of qualified *tuition and fees* for a *more-than-half-time student* in their first two school years of post secondary education. Available until the student has claimed the credit twice already or is starting their junior year on January 1.
- Must be pursuing an undergraduate degree or other credential
- Student also must not have been convicted of a felony involving the possession or distribution of a controlled substance.

Lifetime Learning Credit (per return)

- 20% of the first \$10,000 of qualified tuition and fees
- Available for all years of postsecondary education and classes to improve job skills.

Rule for both Hope and Lifetime Learning Credits (Form 8863)

- Phase out begins at \$48,000 (\$96,000 MFJ)
 - For Hope and Lifetime Learning Credits *only* whoever is eligible to claim the student's exemption can take the expenses, regardless of who actually paid them (as long as it's not a scholarship).
 - Parents may elect not to claim the child's exemption to allow the child to claim the hope or lifetime learning credits. If the parents are qualified to claim the child, the child still cannot claim their own exemption
- Eligible Institution is one that is eligible to participate in a student aid program administered by the department of education.

Tuition and fees Deduction

- ☑ Deduct up to \$2,000 of qualified educational expenses paid by taxpayer or spouse for their own or dependents education as an above the line adjustment. \$4,000 if AGI is below \$65,000 (\$130,000 MFJ)
- ☑ Savings depend on taxpayer's marginal tax rate (and what other credits or deductions the taxpayer has that are limited by AGI).
- ☑ Deduction ends (no phase out) at AGI of \$80,000 (\$160,000 MFJ)
- ☑ Student must be enrolled in one or more courses at an eligible institution and have either a high school diploma or GED (notice no degree or job improvement requirement)
- ☑ Taxpayer can claim the deduction for a dependent only if they have paid the expenses (e.g. parent cannot take deduction if the child paid the expenses). – most payments directly to the school (grandma, ex-spouse, etc.) are treated as if they were paid by the student.
- ☑ Form 8917 was created for 2007 returns to report this deduction.

Exclusion of U.S. Savings Bond Interest (Form 8815)

- ☑ Exclude U.S. Series EE or I Bond interest if proceeds are used to pay qualified education expenses.
- ☑ Savings depend on taxpayers marginal tax rate, but exclusion begins phasing out at \$67,100 (\$100,650 MFJ or QW).
- ☑ Bonds must have been purchased and held by an individual who is at least 24 on the issue date, and cannot be gift bonds.
- ☑ Qualified expenses include tuition, fees, and *contributions to a QTP or ESA*



■ Tax Planning Opportunity

Coverdell Education Savings Accounts (ESAs)

- ☑ Earnings are tax free if distributions are used for qualifying educational expenses – expenses required for enrollment or attendance at a qualified institution, *including elementary and secondary school* expenses. elementary or secondary school expenses include:
 - ☐ Tuition, fees, books, supplies, tutoring, equipment, and special needs services
 - ☐ Room, board, uniforms, and transportation in connection with attendance
 - ☐ Computer technology and internet if it is to be used by the beneficiary or their family during the years the beneficiary is enrolled in elementary or secondary school (entertainment software, e.g. games, are excluded)
- ☑ Tax savings will vary based on return on investment and taxpayers marginal tax rate. Taxpayer may have an itemized deduction (line 23 of Sch A) if the entire balance of the account has been distributed and distributions are less than the total contributions.
- ☑ Phase out begins at an AGI of \$110,000 (\$220,000 MFJ).
- ☑ Annual contributions capped at \$2,000 per beneficiary for all accounts
- ☑ Contributions can only be made until beneficiary reaches age 18, unless they are special needs
- ☑ Mandatory withdrawals at age thirty (unless the student is disabled). Can be transferred to a member of the beneficiary's family (looks like head of household rules) without tax consequences if they are under 30 or special needs.
- ☑ Can be used with Hope or Lifetime Learning credits, as long as the same expenses aren't used for both.
- ☑ Savings probably won't be significant.

Qualified Tuition Plans (QTPs or 529 plans)

- ☑ No AGI phase-outs and contributions are limited only by the gift tax exclusion. (Contributions should not exceed reasonable anticipated expenses of the student)
- ☑ Contributions cannot be made to QTP and Coverdell ESA in the same year.
- ☑ Hope or lifetime learning credit can be taken in a year distributions are made, but not for expenses paid with distributions.
- ☑ With no mandatory withdrawals, not only can the tax savings be significant, but QTPs could potentially be a part of estate planning for wealthy individuals.
- ☑ Accounts can be rolled over, transferred, or have designated beneficiary changed without transferring accounts. There is no tax consequence if beneficiary is changed to a member of the original beneficiary's family (looks a lot like the head of household rules)
- ☑ Distributions are tax free if used for qualified educational expenses. Losses on the account may be available under the Coverdell ESA restrictions above.

Student Loan Interest (or what you have to show for their educations)

- ☑ Interest on loans incurred for Taxpayer, Spouse, or Dependent
(Note, taxpayer may have a qualified dependent even if the dependent fails the joint return or gross income test, or if the taxpayer is a dependent themselves)
- ☑ Paid or incurred within a reasonable time
- ☑ Student must have been enrolled at least half time at an eligible educational institution
- ☑ Proceeds used for tuition, fees, room and board (restrictions apply), books, supplies, equipment and "other necessary expenses" – reduce qualified expenses for most tax-free payments.
- ☑ Excluded on the federal return up to \$2,500. Phase out begins at \$55,000 (\$115,000 MFJ) and ends at \$70,000 (\$140,000 MFJ).
- ☑ Taxpayer can only deduct payment that they made and were legally obligated to make (watch for this when the child takes on the loan payments after graduation).

Student loan cancellation exceptions to forgiveness of debt income

- ☑ Must be a provision for cancellation of debt if the student works a certain period of time, in certain professions, for any of a broad class of employers.
- ☑ Repayment assistance from National Health Service Corp, and similar state programs are generally tax free.

Exception to the Penalty for Early IRA Distributions

- ☑ Allowed for qualified expenses for taxpayer, spouse, or descendent (regardless of dependency)
- ☑ Includes tuition, fees, books, supplies, equipment, and room and board for a more than half-time student.

California Conformity



California does not conform (or has no parallel credit) to the Hope and Lifetime learning credit and tuition and fees deduction. All U.S. savings bond interest is exempt from CA taxation.

Terminal Terminology:

Full time student – student taking at least half of a full time course load, as defined by the institution, for at least one academic period

Tuition and related fees (including books) if required to be purchased from the institution as a condition of enrollment, net of any nontaxable scholarships or expenses paid with tax-free distributions from Coverdell ESA or QTPs or with tax free education benefits paid by employer.

Eligible institution – generally one that is eligible to participate in federal student aid programs (tax-free scholarships have a different definition). For Coverdell ESA, may also be an elementary or secondary institution recognized by the state.

In Summary

Item	Books, Supplies, Equipment and Room and Board allowed?	Use with Hope/Lifetime for same Student	Who gets it	Special Restrictions
Lifetime	No	No	Follows exemption	
Hope	No	No	Follows exemption	Freshman or Sophomore Standing, Degree Candidate or pursuing a credential. Must be enrolled more than half-time
Tuition and Fees Deduction	No	No	Payor only, must claim exemption if expenses were paid for a dependent	
ESA	Yes – plus <ul style="list-style-type: none"> • QTP contribution • Certain primary and secondary school expenses • and special needs expenses 	Yes – but not for the same expenses	Tax-free to student	
QTP	Yes, plus special needs expenses	Yes – but not for the same expenses	Tax-free to student	
Student Loan Interest	Yes, plus other necessary expenses (transportation)	N/A	Legally liable payor only	Loan cannot be from a related person or a qualified employer plan
Savings Bonds	No, but, QTP and ESA contributions are allowed	Yes – but not for the same expenses	Tax-free to bond holder	Must be purchased by taxpayer who is over 24.
Tax-free Scholarship	Books Supplies and Equipment only	Yes – but not for the same expenses	Tax-free to student	Must be a degree candidate
Penalty Free Distribution	Yes, plus special needs expenses	Yes, per pub 970 can also be used for expenses paid from a QTP (but not an ESA)	No penalty to account holder	Dependency is not required for distribution used for a descendent

No double dipping – all tax preference items must be reduced by amounts used for other items, including tax-free scholarships, however, you can take credits or deductions for expenses paid with student loans that will later qualify for the student loan interest deduction.

A Brief Word about Financial Aid

Parents of dependent students for financial aid purposes (which is nearly any student under 24 unless married, also a parent, or a veteran) are expected to contribute a percentage of their income and 12% of their assets (after an asset protection reduction) to their child's education.

Students are expected to contribute a percentage of their income and 35% of their assets to their own education.

Theoretically, financial aid, via scholarships, grants or loans, is then supposed to make up the difference between the expected family contribution and the cost of attending college.

Some things your client can do (within reason - I doubt any client will want to reduce their income to \$15,000 a year just for financial aid) to decrease the expected family contribution and possibly increase their eligibility for financial aid.

- Expected family contribution is determined, and then divided by the number of full-time students in the family. For a family with one child attending college, a parent taking more than a half-time load at a local college could double the number of students in the family and halve the family's expected contribution to the education of the child.
- Equity in a primary residence and money in qualified retirement plans are both excluded from the asset calculation. Families wishing to maximize their eligibility for financial aid may consider moving assets into sheltered accounts the year before applying for financial aid. (Contributions to retirement accounts are still included in available income in the year they are made).

Kiddie Tax¹⁸

Children with investment income over \$1,800 are taxed at their parents' marginal rate (on their joint return if MFJ, on the return of the parent with the higher AGI if MFS, or on the custodial parent if HH or Single) until they reach age 18. A dependent child is still allowed a standard deduction of \$900 (or \$300 plus their earned income if higher, up to the standard deduction), and the next \$900 is taxed at the child's marginal tax rate (generally 10%). Anything above \$1,800 is then taxed at the parent's marginal tax rate.

This can be reported and calculated in two ways:

- The parent whose AGI would be used to calculate the kiddie tax (see above) may elect to report their child's income on their own return (Form 8814).
- ☑ All income must be from interest, dividends (including capital gain distributions), and Alaska Permanent Fund dividends, and total less than \$9,000 (ten times the \$900 taxed at the child's rate).
- ☑ No estimated tax payments or back-up withholding were done for the child.
- ☑ Child cannot file a joint return for 2007
- ☛ Making this election will include the child's income in the parent's AGI, which can have serious tax consequences if the parent is at or near any AGI phase-outs for credits or deductions, claims any itemized deductions limited by AGI, is eligible for EIC, or subject to AMT.
- ☛ If the child's income includes qualified dividends or capital gain distributions, the first \$900 of taxable income will be taxed at 10% -- not the 5% capital gains rate that may be available to a child on their own return.
- ☛ If the child is eligible to itemize deductions (for charitable contributions or investment expenses), claim the larger standard deduction for blindness, or deduct penalties for early withdrawal of savings, none of these deductions will be available to the parent if they report their child's income.
- The child can file their own return, using form 8615 to calculate the amount of tax on investment income over \$1,800.



Nanny Tax

As you also know, wages paid to a household employee can be subject to FICA, FUTA, SUI and SDI tax/withholding.

- Most workers in or around the home are considered the taxpayers' employees by the IRS and EDD. Self-employed workers who control how the work is done, provide their own tools, and offer services to the general public are not employees of the taxpayer. Home-workers who are employees of an agency that controls how the work is done are not considered the taxpayers' employees either.
- The IRS will allow household employers to report and pay employer taxes on their 1040 via Schedule H. Taxpayer will need to apply for an EIN.
- Taxpayer is required to complete I9s for all employees
- W2s/W3 must still be prepared and issued to the employees and filed with SSA.
- The Employment Development Department will allow small household employers (total wages under \$20,000) to pay their employer taxes annually; however, quarterly reporting is still required. Household employers should use the DE 1HW to apply for a SEIN and mark yes in Item I to elect annual payments or file form DE-89 "Household worker election notice" to elect annual payment due *January 31*.

Nanny Tax Limits¹⁹

- Wages of over \$1,500 to one employee are subject to FICA. Employer has the option of not withholding FICA and grossing up the employee's income subject to federal Income tax for the employee's portion of Social Security and Medicare paid by the employer (X the "hshld emp" box for kind of payer on the W3).
- Total wages of over \$1,000 per quarter cause the taxpayer to become subject to FUTA.
- Total cash wages of over \$750 per quarter are subject to SDI withholding. Once the taxpayer becomes subject to SDI, they will remain subject to SDI through the end of the *following* calendar year. Does not include social security taxes paid by employer. Cash wages also do not include meals or lodging provided for employer's convenience.
- Wages of over \$1,000 per quarter are subject to SUI and ETT for all employees
- PIT withholding is not required
- Household employers paying more than \$20,000 total wages must pay employer taxes quarterly.
- Spouse, Child under 21, parents (generally), and most employees under 18 (unless providing household services is their primary occupation) excepted
- California generally exempts children under 18 employed by their parents, spouse, RDPs, and parents.²⁰

Forms Required

Federal		California	
Federal Employer ID Number (SS-4) (for type of entity, select other and write in household employer)	Completed when taxpayer plans to or actually hires employees, although most clients put it off until preparing to file their income tax return without ill effect	Registration form for Employers of Household Workers (DE 1HW) Employer of Household Worker Election Notice DE89 (or mark yes on item I of DE 1HW)	Within 15 days of paying 750 in cash wages (delaying can result in disallowance of household employer status)
I-9 Employee Eligibility Verification for each employee. Available at www.uscis.gov	Completed when employee is hired (retained by client, not required to submit unless requested by Department of Homeland security)	New Employee Registry (DE 34)	Within 20 days of hire

W-2 for each employee paid over 1,500 in cash wages, subject to Social Security, Medicare, or Federal Income Tax Withholding (And W-3 summary for all W-2's) issued	To employee by January 31 of following year, to Social Security Administration by Feb 28 th of following year. Employers are allowed an additional month if they file electronically	Quarterly report of wages and withholding for Employers of Household Workers DE 3BHW	Due at end of month following quarters end
Schedule H	Due date (including extensions) of return	Annual payroll tax return for employers of household workers DE 3HW	Due Jan 31 of following year

Games You Can Play With a Child and a Schedule C

Step one: Have your client hire their child at a reasonable rate for work the child actually performs.

- Wages paid to the taxpayer's child are not subject to FICA or FUTA taxes if the child is under 18²¹.
- California exempts wages paid to a child under 18 working for their parents (step-children, foster children and sons/daughters in law are excluded) from SUI and SDI²²
 - Spouse's wages are not subject to FUTA, California excepts spouses and RDP's from SDI or SUI
- The wages paid to a child are fully deductible on the schedule C at the taxpayer's marginal tax rate, and will be taxed on the child's return at their marginal tax rate, which, presumably, is lower.
- Earned income is not subject to kiddie tax, and may allow the child to contribute to their own Roth or Traditional IRA, with plenty of time to grow.
- The taxpayer may save on babysitting ☺
- Taxpayer will have to comply with payroll reporting (which may be an upside if you offer your clients bookkeeping services).
- Taxpayer will have to spend more time with their kids ☹



Step two: Have the taxpayer offer employees medical insurance, Health Savings Accounts, tuition assistance, retirement plans etc. (Children under 18 may not be able to participate in all of these) to their employees²³. I strongly recommend encouraging the taxpayer to engage a professional administrator to make sure that the plans are compliant with all requirements (including nondiscrimination or safe harbor) and deadlines.

- Any of the child's expenses that qualify as non-taxable fringe benefits above are not only an above the line deduction, but reduces income subject to self-employment tax.
- Money put into a Health Savings Account will have **lots** of time to grow before the child (hopefully) needs it. *** *California does not conform regarding HSA contributions and distributions.* ***
- A tuition assistance plan will allow the taxpayer to deduct the first \$5,250 of tuition as an employee benefit if the child is still an employee when they start college. The balance of educational expenses would still be eligible for education related tax benefits.
- Small employers can take a credit of up to 50% of the first \$1,000 in expenses paid to set up a retirement plan (Form 8881 included in general business credit Form 3800). By the way, limited expenses of offering employees retirement planning services may be a nontaxable fringe benefit.
- If the taxpayer employs a spouse, they can also take a credit 25% of daycare facilities provided, including costs incurred under contract with a qualified daycare facility (Form 8882 included in general business credit on Form 3800). Costs not used for the credit can still be deducted as an employee benefit expense. The Taxpayer may also qualify for the CA Employer Childcare Program/Contribution Credit (form 3501) as well.
- Benefits will have to be offered to non-family employees as well.
- Most programs will have administrative costs to be weighed against the tax benefits.

Games You Can Play With a Child and Unearned Income

While children under 18 are subject to Kiddie Tax, their \$900 standard deduction is tax-free and the next \$900 taxed at their marginal tax rate before Kiddie Tax rates kick in. Transferring investments to children can still reduce their parents AGI and taxes more than it increases the child's taxes. Also, for parents with non-negligible investment income and low earned income, transferring investments to the child may make the parent eligible for the earned income credit when they were not previously qualified.

There are several ways to keep control over gifts of money to minors:

- Universal Transfer to Minors Act account: an account opened with an adult named as custodian for the minor child. The custodian (who can be the child's parent) can manage the account as she sees fit, including making distributions from the account for the child's support, education, or general benefit. The child generally will not have access to the funds in a UTMA account until they have reached age 18. For estate planning, any UTMA's where the donor is also the custodian will be considered part of the donor's estate if the donor dies while serving as custodian. The increase in the age for the kiddie tax makes these less appealing than they once were, especially since, as assets of the child, the expected family contribution from these accounts for financial aid purposes will be 35% annually.
- Transfers to a trust: Trusts can give donors a great deal of control of how minors can use funds given to them, even after they have attained their majority. However, as you recall, gifts of future interests are not eligible for any exclusion from the gift tax, and most trusts, where the child doesn't have access to the funds, will be considered a gift of a future interest and not eligible for the gift tax exclusion. Two options are available to clients wishing the best of both worlds.
 - Section 2503(c) trusts: Assets may be held in trust until the child reaches age 21, and gifts to the trust are treated as gifts of present interests. The trustee cannot be prevented from making distributions for the child's health, education and support. Like UTMA accounts, if the donor serves as trustee, the trust will be included in the donor's estate.
 - Trusts with Crummey Provisions (yes, that's really their name): Trusts where the beneficiary has the option (generally never exercised) to withdraw the donor's current year contributions within a specified time frame (usually 30 to 60 days). Having the right to withdraw the contributions is sufficient to qualify them as gifts of a present interest, and therefore eligible for the gift tax exclusion.
- Transfers to a Coverdell ESA or QTP: also considered a gift of a present interest regarding the gift tax exclusion. Earnings are tax free if distributions are used for qualified educational expenses.
 - The student owns Coverdell ESAs but they are treated as parents' assets, subject to a lesser percentage of expected family contribution.
 - The donor owns a QTP, but they are treated as parents' assets subject to a lesser percentage of expected family contribution.
 - 10% penalty plus tax on nonqualified distributions may be a sufficient disincentive to prevent the child from using funds for other than educational expenses (but probably won't be).

Appendix: Mr. & Ms. Ed

Mr. Ed is employed as a horse (of course), Ms. Ed is employed full time as a stay at home mare, and does the bookkeeping for Mr. Ed's horse business. They have a daughter, Filly (12), and a son, Colt (19), who is attending college, for which Mr. and Ms. Ed pay \$6,000 per year in tuition and the same in books, supplies, and related expenses. Mr. Ed has net earnings from self employment of \$90,000; Ms. Ed averages an annual return of \$3,000 from her various investments, with assets of \$50,000; The Eds pay \$4,800 in health insurance annually. 2008 Tax Rates

Case Number	Original	Hire Ms. Ed		Fun with Unearned Income			Fun with Earned Income		
		Two	Three	Four	Five	Six	Seven	Eight	Nine
Summary of Mr. & Ms. Ed's 1040									
Interest Income	\$3,000	\$3,000	\$3,000	\$1,560	0	0	\$3,000	\$2,520	\$2,520
Wages	0	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Business Income	90,000	86,771	81,971	81,971	81,971	81,971	70,654	70,654	65,404
Total Income	93,000	92,771	87,971	86,531	84,971	84,971	76,654	76,174	70,924
Less 1/2 of SE Tax	6,359	6,130	5,791	5,791	5,791	5,791	4,992	4,992	4,621
Less SE Health Insurance	4,800	4,800	0						
Adjusted Gross Income	81,841	81,841	82,180	80,740	79,180	79,180	71,662	71,182	66,303
Standard Deduction	10,900	10,900	10,900	10,900	10,900	10,900	10,900	10,900	10,900
Exemption Deductions	14,000	14,000	14,000	14,000	14,000	14,000	14,000	14,000	14,000
Taxable Income	56,941	56,941	57,280	55,840	54,280	54,280	46,762	46,282	41,403
Tax	7,739	7,739	7,789	7,573	7,339	7,339	6,212	6,140	5,408
Child Tax Credit	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Hope Credit	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800
Income Tax	4,939	4,939	4,989	4,773	4,539	4,539	3,412	3,340	2,608
Self Employment Tax	12,717	12,260	11,582	11,582	11,582	11,582	9,983	9,983	9,241
Total Tax	17,656	17,199	16,571	16,355	16,121	16,121	13,395	13,323	11,849
Taxes paid by Filly and Colt					120				
Employment Taxes, Including Withholding		459	459	459	459	459	1,293	1,293	1,293
Total taxes paid	17,656	17,658	17,030	16,814	16,700	16,580	14,688	14,616	13,142
Change in Tax	\$0	\$2	(\$625)	(\$841)	(\$955)	(\$1,075)	(\$2,968)	(\$3,040)	(\$4,514)

Case Two	Hire Ms. Ed for \$3,000 per year, Mr. Ed pays employer's half of payroll taxes of \$229.50
Case Three	Offer employees and their families health insurance
Case Four	Transfer \$12,000 of investment assets to each child \$720 in investment income per child
Case Five	Transfer Assets to both Children - even with gift splitting there will be some gift tax implications
Case Six	Transfer Assets to QTP for Both Children - will need to do a gift tax return
Case Seven	Hire Filly & Colt for \$5,450 per year (Continuing from Case Three)
Case Eight	Filly and Colt put \$4,000 per year into Roth IRA's (reducing Ms. Eds' Investments)
Case Nine	Offer Colt \$5,250 in Educational Assistance as an employee benefit

Appendix: Save Early and Often

Assumption: Annual rate of return of 6% Compounded Annually
 Annual contribution of 3,000

Age	Contributions	Balance	Contributions	Balance	Contributions	Balance
12	\$3,000	\$3,000				
13	3,000	6,180				
14	3,000	9,551				
15	3,000	13,124				
16	3,000	16,911				
17	3,000	20,926				
18	3,000	25,182				
19	3,000	29,693				
20	3,000	34,475	\$3,000	\$3,000		
21	3,000	39,544	3,000	6,180		
22	3,000	44,917	3,000	9,551		
23		47,612	3,000	13,124		
24		50,469	3,000	16,911		
25		53,497	3,000	20,926		
26		56,707	3,000	25,182		
27		60,109	3,000	29,693		
28		63,716	3,000	34,475		
29		67,539	3,000	39,544		
30		71,591	3,000	44,917		
31		75,886	3,000	50,612	\$3,000	\$3,000
32		80,439	3,000	56,649	3,000	6,180
33		85,265	3,000	63,048	3,000	9,551
34		90,381	3,000	69,831	3,000	13,124
35		95,804	3,000	77,021	3,000	16,911
36		101,552	3,000	84,642	3,000	20,926
37		107,645	3,000	92,721	3,000	25,182
38		114,104	3,000	101,284	3,000	29,693
39		120,950	3,000	110,361	3,000	34,475
40		128,207		116,983	3,000	39,544
41		135,899		124,002	3,000	44,917
42		144,053		131,442	3,000	50,612
43		152,696		139,329	3,000	56,649
44		161,858		147,689	3,000	63,048
45		171,569		156,550	3,000	69,831
46		181,863		165,943	3,000	77,021
47		192,775		175,900	3,000	84,642
48		204,342		186,454	3,000	92,721
49		216,603		197,641	3,000	101,284
50		229,599		209,499	3,000	110,361
65		550,248		502,079		264,488
Total	\$33,000	\$550,248	\$60,000	\$502,079	\$60,000	\$264,488

-
- ¹ www.cnpp.usda.gov "Expenditures on Children by Families, 2007 Annual Report" for before tax income from \$45,800 to \$77,100.
 - ² http://planit.cuna.org/article.php?doc_id=25 "How Much Does College Cost"
 - ³ IRS pub 17 – "personal exemptions and dependents" used as basis of dependency discussion
 - ⁴ IRS Rev proc. 2007-66 (used for all federal inflation adjusted figures)
 - ⁵ www.ftb.gov "Form 540/540A Instructions"
 - ⁶ From IRS Pub 17 Ch 2 Filing Statuses
 - ⁷ From IRS Pub 972 Child Tax Credit
 - ⁸ From IRS from 2441 and from 2441 instructions; and FTB form 3506 and 3506 instructions
 - ⁹ FTB Pub 802 Long Term Care Credit
 - ¹⁰ From IRS Pub 596 Earned Income Credit
 - ¹¹ From 2005 Tax Book by Tax Materials Inc
 - ¹² <http://www.irs.gov/individuals/article/0,,id=150531,00.html>
 - ¹³ IRS From 8839 Instructions
 - ¹⁴ FTB 540 Instructions
 - ¹⁵ <http://www.irs.gov/newsroom/article/0,,id=120665,00.html>
 - ¹⁶ FTB Combined 540/540A Instructions
 - ¹⁷ From IRS Pub 970 Tax Benefits for Education
 - ¹⁸ From IRS Form 8615 Instructions, 2008 figures from IRS Rev proc 2007-66
 - ¹⁹ From IRS Schedule H Instructions; FTB Pub DE 8829 "Household Employers Guide 2006"
 - ²⁰ FTB Pub DE 8829 Household Employers
FTB Pub DE 231EE Exempt Employment
 - ²¹ IRS Pub 15 Employers Guide
 - ²² FTB Pub DE 231FAM
 - ²³ IRS Pub 15B Employer's Tax Guide to Fringe Benefits (I treat this as a catalog for my small sole props)