

The Tax Side of Child Care

By Lisa Niser, NPN member since 2003

You've utilized the wealth of information available through NPN to find the best child care provider for your children, but have you thought about what it will truly cost to pay for that care and if there are any child care-related tax benefits that you can take advantage of? This is the nitty-gritty that often gets overlooked but should be an important part of your decision-making process.

Nanny tax

When you hire a nanny, you set yourself up as a household employer in the eyes of the IRS. This means that you are now liable for employment taxes (Social Security and Medicare) as well as federal and state unemployment taxes. The employment taxes equal 7.65% of the nanny's earnings. However, if you also choose to pay the nanny's share of these taxes, which many families do, your liability would double to 15.3%. The federal unemployment tax is 0.8% on a maximum of \$7,000, or \$56, and the state unemployment tax rate varies but typically starts at 3.9% on a maximum of \$12,300.

Besides these taxes, you may also incur expenses to have a tax advisor set you up as a household employer as well as prepare the W-2 for your nanny and the tax forms related to the employment and unemployment taxes. In addition, you may need advice on how to handle the federal and state income tax part of the equation so that you can properly explain it to your potential employee and understand how the withholding and submitting of those taxes works.

Tax savings opportunities

To help minimize your child care costs, there are two strategies you should look into: Dependent Care Accounts and the Child and Dependent Care Credit.

A **Dependent Care Account** allows you to put aside part of your salary each pay period on a pre-tax basis to reimburse eligible expenses paid so that you and your spouse can work. The maximum you can set aside each year is the lesser of \$5,000 or the lower-earning spouse's earned income. If you are in the 25% tax bracket, you would save \$1,250 if you contribute the full amount! Enrollment into an account typically occurs only once a year during benefits enrollment time so if you've missed the deadline for this year, keep your eyes open for next year. Once your children are in elementary school, you can no longer use the funds to cover tuition but funds spent on after-school care (not classes) and summer camp qualify as long as both spouses have earned income.

The **Child and Dependent Care Credit** is taken on your tax return, so if you missed the deadline for utilizing a dependent care account or if your employer doesn't offer one, you can still save on your child care costs. Eligible expenses are limited to the lower of \$3,000 for one qualifying child (\$6,000 for two or more qualifying children) or the lower-earning spouse's earned income. This amount must be reduced by the amount reimbursed through a dependent care account. The amount deposited

into a dependent care account is reported to the IRS in box 10 on Form W-2 so look there if you've forgotten how much you contributed.

The Child and Dependent Care Credit is equal to a maximum of 35% of eligible expenses. This rate is reduced by 1% for each \$2,000 your adjusted gross income exceeds \$15,000 but cannot be reduced below 20%. The 20% rate starts at adjusted gross incomes of \$43,000. To claim the credit, complete Form 2441 and attach it to your Form 1040. You are required to report either your nanny's social security number or your child care center or school's employer identification number on the form so be sure to get that information before tax time.

Child Tax Credit

This credit doesn't directly impact your child care costs but can be claimed in addition to the child and dependent care credit. With this credit, you may be able to reduce the federal income tax you owe by up to \$1,000 for each qualifying child under the age of 17. This amount is limited if your modified adjusted gross income is above \$110,000 and you are married filing jointly, \$55,000 if you are married filing separately and \$75,000 for all others. In addition, the Child Tax Credit is generally limited by the amount of the income tax you owe as well as any alternative minimum tax liability.

If the amount of your Child Tax Credit is greater than the amount of income tax you owe, you may be able to claim some or all of the difference as an "Additional" Child Tax Credit. The Additional Child Tax Credit may give you a refund even if you do not owe any tax. You may claim the Child Tax Credit on Form 1040 or 1040A.

Illinois Schedule ED

While school tuition no longer qualifies as child care once your children start Kindergarten and there aren't any federal tax credits to help offset it, Illinois does provide the Credit for K-12 Educational Expenses to help reduce those costs. This credit is 25% of your tuition, book and lab fees in excess of \$250 up to a maximum of \$500 per family. You can claim this credit by completing Schedule ED and attaching it to your Illinois tax return. If you are eligible for this credit but missed it on prior returns, you can go back and amend returns up to three years from the date they were due. A tax advisor can assist you with preparing the amended returns.

Taxes (and children!) are tricky and tax laws are constantly changing. However, if you keep your eyes open or have a good tax advisor who will keep his/her eyes open for you, you can maximize your tax benefits and have more money available for your family.

Lisa Niser has been a tax advisor since 1994. She worked at two Big Four Accounting Firms before starting her own practice after the birth of her oldest child. She is an enrolled agent, licensed to represent clients before the IRS and holds a master's in taxation degree from DePaul University.