

CHAPTER 1

You and Your Family

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Do the old clichés still ring true? Can two still live as cheaply as one? Are things really cheaper by the dozen? For tax purposes, there may be a penalty or bonus for being married versus single, but there are certain tax breaks for building a family.

This chapter explains family-related tax benefits, such as exemptions and tax credits related to your children and the consequences of marital dissolutions. For more information on these topics, see IRS Publication 501, *Exemptions, Standard Deduction, and Filing Information*; IRS Publication 503, *Child and Dependent Care Expenses*; IRS Publication 504, *Divorced or Separated Individuals*; IRS Publication 596, *Earned Income Credit*; and IRS Publication 972, *Child Tax Credit*.

Marital Status

Whether you are married or single has a significant impact on your taxes. In some cases, being married results in a “marriage bonus,” such as effectively averaging taxes when one spouse works and the other does not. In other cases, being married results in a “marriage penalty,” such as the fact that two working spouses earning about the same likely will pay higher total tax than if they were single. For some tax rules, a married couple has the identical tax break as a single individual, such as the \$3,000 capital loss deduction against ordinary income, which is a distinct disadvantage for those who are married. For some tax rules, a married couple has double the tax break for singles, such as the ordinary loss deduction for so-called Section 1244 stock, so marital status makes no difference here.

Technically, there are a number of filing statuses that determine eligibility for various tax breaks:

- Married filing jointly
- Married filing separately
- Head of household
- Unmarried (single)
- Qualifying widow(er) with a dependent child

You need to know which term applies to you. The terms are not further defined here, so check IRS Publication 501 if you are unsure. Note that under federal tax law, the terms “husband,” “wife,” and “spouse” are gender neutral. The term “husband and wife” means two individuals lawfully married to each other. However, those in a civil union or domestic partnership are not married for federal income tax purposes.

Personal Exemption

Each taxpayer (other than someone who is another taxpayer’s dependent) automatically is entitled to a deduction just for being a taxpayer. The amount of the deduction, called the exemption amount, is a fixed dollar amount (\$4,050 in 2016).

Benefit

You can claim a deduction for yourself, called a personal exemption. In 2016, the exemption amount is \$4,050 (each year it is indexed for inflation). Table 1.1 shows you the value of your personal exemption for your tax bracket in 2016 (the amount of taxes you save by claiming it).

TABLE 1.1 Value of Your Personal Exemption in 2016

Your Top Tax Bracket	Value of Your Exemption
10%	\$ 405
15%	608
25%	1,013
28%	1,134
33%	1,337
35%	1,418
39.6%	1,604

Conditions

There are no conditions to claiming this deduction; it's yours because you are a taxpayer and the law says you are entitled to it.

Each spouse is entitled to his or her own personal exemption. On a joint return, 2 personal exemptions are claimed. If you are married but file a separate return, you can claim both deductions (an exemption for you and an exemption for your spouse) if your spouse has no income and is not the dependent of another taxpayer.

However, you *cannot* claim the personal exemption if you can be claimed as a dependent on another taxpayer's return. For example, a child who is the parent's dependent cannot claim a personal exemption on the child's own return.

Planning Tip

You cannot claim any personal or dependency exemption for alternative minimum tax (AMT) purposes, a shadow tax system designed to ensure that all taxpayers pay at least some tax. A large number of exemptions can substantially reduce or even eliminate any regular tax. So if you have a large number of exemptions, you may trigger or increase AMT liability. You may wish to engage in some tax planning to minimize or eliminate your AMT liability.

Pitfalls

The deduction for personal exemptions can be reduced or even eliminated entirely if your income is high enough. Personal exemptions are subject to a phaseout when adjusted gross income (AGI) exceeds a set amount based on filing status. Table 1.2 shows the AGI threshold for the start of the phaseout; it also shows the point at which the deduction for personal exemptions is completely eliminated. The phaseout is 2% of each \$2,500 (or fraction of \$2,500) of AGI over your threshold amount.

4 1001 DEDUCTIONS AND TAX BREAKS 2017**TABLE 1.2 2016 Phaseout for Personal Exemptions**

Filing Status	AGI—Beginning of Phaseout	AGI—Completed Phaseout
Married filing jointly and surviving spouses	\$311,300	\$433,800
Heads of households	\$285,350	\$407,850
Singles	\$259,400	\$381,900
Married filing separately	\$155,650	\$216,900

Example

You are single (with no dependents) and your adjusted gross income for 2016 is \$260,000. You are subject to the phaseout of your \$4,050 personal exemption. Your exemption is reduced by 2% because your income exceeds your \$259,400 threshold by \$600, which is a fraction of \$2,500. Your exemption amount is \$3,969 ($\$4,050 - [\$4,050 \times 2\% = \$81]$). If your AGI is more than \$381,900, you cannot claim any exemption amount.

If a parent waives the exemption for a child to enable the child to claim an education credit (see Chapter 3), the child cannot claim his or her own exemption.

Where to Claim the Personal Exemption

You claim the exemption directly on your tax return in the “Tax and Credits” section of Form 1040 or the “Tax, Credits and Payments” section of Form 1040A; no special form or schedule is required. If you are filing Form 1040EZ, the exemption amount is built into the tax table (you can file this return only if you are single or married filing jointly with no dependents); you don’t have to subtract it anywhere on the return.

If your AGI exceeds the beginning of the phaseout range, use a worksheet in the instructions for the return to figure the phaseout of your exemption.

Dependency Exemption

A fixed deduction (\$4,050 in 2016) is allowed to every taxpayer who supports another person and meets other tests described later. This deduction is called a dependency exemption.

Benefit 

You may be entitled to a dependency exemption for each person you support if certain conditions are met. Like the personal exemption, each dependency exemption in 2016 is a deduction of \$4,050.

Conditions

There are 2 classes of dependents: qualifying children and all other qualifying individuals. Different conditions apply to each class of dependents.

For a qualifying child, there are 4 conditions:

1. Being your child
2. Modified support test
3. Citizenship test (see end of “Conditions” section)
4. Joint return test (see end of “Conditions” section)

BEING YOUR CHILD

For purposes of a qualifying child, your children include your natural children, stepchildren, adopted children (including those placed for adoption), and eligible foster children (those placed with you by an authorized adoption agency or court). A qualifying child also includes grandchildren, brothers and sisters (including stepsiblings), and children of siblings (nieces and nephews who are younger than you). The child must be under age 19, under age 24 and a full-time student, or permanently disabled (any age).

Your child must live in your household for more than half the year. A child kidnapped by someone other than a family member continues to be treated as a member of your household until the year in which he or she would have attained age 18.

MODIFIED SUPPORT TEST

A qualifying child must not have provided more than half of his or her own support (you do not have to show you paid more than half the child’s support). Amounts received as scholarships are *not* counted as support. There is no gross income test for a qualifying child as there is for a qualifying relative explained later.

Special rule for divorced or separated parents: The exemption belongs to the noncustodial parent if these conditions are met:

- The child receives more than half of his/her support from the parents.
- A decree of divorce or separation agreement between the parents states that the noncustodial parent is entitled to claim the dependency exemption or the custodial parent signs a written declaration (IRS Form 8332) that he/she will not claim the exemption.

If there is no divorce decree or separation agreement with a statement on the dependency exemption for the noncustodial parent or the custodial parent fails to sign a written declaration waiving the exemption, then a so-called tiebreaker rule applies. Under this rule, the exemption belongs to the parent with whom the child resided for the greater amount of time, or if equal time, then to the parent with the higher adjusted gross income. Thus, the custodial

parent will usually prevail because the child is a member of the custodial parent's household for more time during the year than the child is a member of the noncustodial parent's household.

There are 5 tests for claiming a dependency exemption for someone who is not a qualifying child. You must satisfy *all* of them:

1. Relationship or member of the household test
2. Gross income test
3. Support test
4. Citizenship or residency test
5. Joint return test

RELATIONSHIP OR MEMBER OF THE HOUSEHOLD TEST

The person you claim as a dependent must either be a relative (whether or not they live with you) or a member of your household. Relatives who do not have to live with you in order to qualify as your dependent include:

- Child, adopted child, or stepchild (other than a qualifying child)
- Grandchild (other than a qualifying child)
- Great-grandchild (other than a qualifying child)
- In-law (son, daughter, father, mother, brother, or sister)
- Parent or stepparent
- Sibling, stepbrother or stepsister, half-brother or half-sister
- Uncle, aunt, nephew, or niece if related by blood

Any other individual, including, for example, a cousin, must be a member of your household for the entire year (not counting temporary absences).

GROSS INCOME TEST

The person you claim as a dependent must have gross income of less than the exemption amount—\$4,050 in 2016.

Gross income means income that is subject to tax. It does not include tax-free or excluded items, such as municipal bond interest, employee fringe benefits, or gifts. Social Security benefits are gross income only to the extent they are taxable (which may be 50% or 85%, depending on the recipient's income and Social Security benefits).

SUPPORT TEST

You must provide more than half of the person's support for the year (or meet the multiple support rules discussed later). Generally, this test does not present a problem; you may be the person's only means of support.

But where the person pays some of his or her own support while receiving help from you and other sources, you need to look closely at whether you pay more than half of the person's support. "Support" is different from "income." You need to look at what is *spent* on personal living needs and not what the person *receives* in the way of income. Government benefits payable to the person, including Social Security benefits, are treated as the person's own payment of support (whether or not actually spent on personal living needs).

EXAMPLES OF SUPPORT ITEMS

Clothing

Education expenses (If your child takes out a student loan that he or she is primarily obligated to repay, the loan proceeds count as the child's own payment of support.)

Entertainment

Food

Lodging (If the person shares your home, support is based on the fair rental value of the room or apartment in your home, including a reasonable allowance for heat and other utilities.)

Medical expenses (for details see Chapter 2)

Recreation, including the cost of a television, summer camp, dance lessons, vacations, and a wedding

CITIZENSHIP OR RESIDENCY TEST

The person you claim as a dependent must be a U.S. citizen or national, or a resident of the United States, Canada, or Mexico.

JOINT RETURN TEST

If you are claiming an exemption for someone who is married, the person may not file a joint return with his or her spouse. However, this joint return test is not failed if a joint return is filed merely to claim a refund and both spouses have income under the exemption limit.

Example

You are supporting your married daughter. Both she and her husband are graduate students who each earned \$3,000 as teaching assistants and file a joint return to claim a refund of taxes paid on these earnings. Even though your daughter files a joint return, you can still claim her as a dependent (assuming other tests are met).

Planning Tips

Even if you do not provide more than half the support of another person, you may still qualify for the deduction if you contribute more than 10% of the person's support and, together with others, contribute more than half the person's support. Then each of the other supporters who contribute more than 10% must agree among themselves who claims the exemption (it cannot be prorated among the supporters).

Example

You and your 2 sisters support your elderly mother. You contribute 40%, Ann contributes 35%, and Betty contributes 5% (your mother pays 20% of her own support). Since you and your sisters contribute more than half of your mother's support, a multiple support agreement is warranted.

However, only you and Ann qualify since you each contribute more than 10% of the support. You and Ann can decide who claims the exemption—it does not matter that you paid more than Ann.

In deciding which person should claim the exemption when more than one person qualifies, the decision should be based on who would benefit more. Factors to consider include:

- Which person is in the higher tax bracket and whether such person is subject to the phase-out of exemptions for high-income taxpayers
- Who examined the exemption in the prior year and who will claim it next year

If all things are equal, then rotate from year to year who claims the exemption (for example, one year you claim the exemption for a parent and the following year your sibling claims it).

Even if you do not qualify to claim a dependency exemption for your child who is over 23 and no longer a full-time student, you may still cover your child under your health care plan up to age 26. The child does not have to be your dependent, or even live with you, in order to be covered by your medical policy.

For couples with a child who are getting divorced, deciding which one should claim the exemption can be contentious. As said earlier, the exemption belongs to the spouse who has physical custody of the child for the greater part of the year. The custodial spouse can waive the exemption in favor of the noncustodial spouse by signing Form 8332; the waiver can be made on an annual or permanent basis. The fact that the divorce decree awards the exemption to the noncustodial spouse does not alleviate the need to obtain the written waiver from the custodial spouse on the IRS form.

Pitfalls

The same phaseout for personal exemptions applies equally to dependency exemptions. Check Table 1.2 earlier in this chapter to see whether you are subject to any phaseout of the deduction for dependency exemptions.

Because of the phaseout for personal exemptions, parents who are splitting up should decide which of them could benefit more from the exemption. For instance, a high-income father who is the custodial parent may wish to negotiate for some consideration by foregoing the dependency exemption for the child. This allows the mother to claim the exemption and increase the overall after-tax income for the family.

If you support a domestic partner or lover and meet all of the tests, you can claim a dependency exemption as long as the relationship does not violate local law. For example, in North Carolina, a man was prohibited from claiming the exemption for his live-in girlfriend because under North Carolina law this cohabitation was a misdemeanor. (Technically, it remains illegal in Michigan, Mississippi, and North Carolina—the law was repealed in Florida in 2016—but these laws against cohabitation may not withstand a challenge today.) In contrast, a man in Missouri was permitted to claim the exemption for his live-in girlfriend because the relationship there was not in violation of state law.

If you can claim an exemption for a partner, you may or may not be able to claim one for the partner's qualifying child. Usually, you do not qualify for an exemption for your partner's child because the child is not your qualifying relative (he or she is the qualifying child of your partner). Under an exception, however, the exemption for the child can be claimed if your partner (for whom the child is a qualifying child) is not required to file a tax return because of low income and does not file a return or files one only to get a refund of withheld income taxes. If, for example, your partner files a return to claim the earned income credit in addition to claiming a refund of withheld income taxes, then this exception to the general rule does not apply.

Where to Claim the Dependency Exemption

You claim the exemption directly on your tax return in the "Tax and Credits" section of Form 1040 or the "Tax, Credits and Payments" section of Form 1040A; no special form or schedule is required. You cannot claim a dependency exemption if you file Form 1040EZ.

If your AGI exceeds the beginning of the phaseout range, use a worksheet in the instructions for the return to figure the phaseout of your exemption.

In the case of divorced or separated parents, the noncustodial parent should attach to his or her return Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, signed by the custodial parent.

Child Tax Credit

The U.S. Department of Agriculture estimates that it costs over \$304,480 to raise a child born in 2016 to age 18 (without adjustment for inflation). In recognition of this cost, you can claim a tax credit each year until your child reaches the age of 17. The credit is currently up to \$1,000 per child. This credit is in addition to the dependency exemption for the child.

Benefit

You may claim a tax credit of up to \$1,000 for each child under the age of 17. If the credit you are entitled to claim is more than your tax liability, you may be entitled to a refund under certain conditions.

Generally, the credit is refundable to the extent of 15% of earned income over \$3,000.

If you have 3 or more children for whom you are claiming the credit, you are entitled to an additional child tax credit. In reality, the additional child tax credit is merely a larger refund of the credit you are ordinarily entitled to. There are 2 ways to figure your refundable amount (the additional child tax credit) and you can opt for the method that results in the larger refund:

1. Fifteen percent of earned income over \$3,000
2. Excess of your Social Security taxes (plus the so-called employer share of self-employment taxes if any) over your earned income credit for the year (the earned income credit is explained in the next main section)

Conditions

To claim the credit, you must meet 2 conditions:

1. You must have a qualifying child.
2. Your income must be below a set amount.

QUALIFYING CHILD

You can claim the credit only for a "qualifying child." This is a child who is under age 17 at the end of the year and meets the definition of a qualifying child explained earlier in this chapter.

MAGI LIMIT

You must have modified adjusted gross income (MAGI) below a set amount. The credit you are otherwise entitled to claim is reduced or eliminated if your MAGI exceeds a set amount. MAGI for purposes of the child tax credit means AGI increased by the foreign earned income exclusion, the foreign housing exclusion or deduction, or the possession exclusion for American Samoa residents.

TABLE 1.3 Phaseout of Child Tax Credit over MAGI Limits in 2016

Filing Status	MAGI Limit
Married filing jointly	\$110,000
Head of household	75,000
Unmarried (single)	75,000
Qualifying widow(er)	75,000
Married filing separately	55,000

The credit amount is reduced by \$50 for each \$1,000 of MAGI or a fraction thereof over the MAGI limit for your filing status. The phaseout begins if MAGI exceeds the limits found in Table 1.3.

Example

In 2016, you are a head of household with 2 qualifying children. Your MAGI is \$80,000. Your credit amount of \$2,000 ($\$1,000 \times 2$) is reduced by \$250 ($\$80,000 - \$75,000 = \$5,000$ MAGI \div [$\$1,000 \times \50]). Your credit is \$1,750 ($\$2,000 - \250).

REFUNDABLE CREDIT

If the credit you are entitled to claim is more than your tax liability, you can receive the excess amount as a “refund.” The refund is limited to 15% of your taxable earned income (such as wages, salary, tips, commissions, bonuses, and net earnings from self employment) over \$3,000. If your earned income is not over \$3,000, you may still qualify for the additional credit if you have 3 or more children.

If you have 3 or more children for whom you are claiming the credit, you may qualify for a larger refund, called the additional child tax credit. You can figure your refund in the usual manner as explained earlier, or, if more favorable, you can treat your refundable amount as the excess of the Social Security taxes you paid for the year (plus the employer equivalent portion of self-employment taxes, if any) over your earned income credit (explained later in this chapter).

Planning Tip

If you know you will become entitled to claim the credit (e.g., you are expecting the birth of a child in 2016), you may wish to adjust your withholding so that you don't have too much income tax withheld from your paycheck. Increase your withholding allowances so that less income tax is withheld from your pay by filing a new Form W-4, *Employee's Withholding Allowance Certificate*, with your employer.

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If you claim the foreign earned income exclusion to exclude income earned abroad up to the annual dollar limit (\$101,300 in 2016), you cannot receive a refundable child tax credit.

For 2016 returns filed in 2017, the IRS is not permitted to issue tax refunds for the refundable child tax credit before February 15, 2017.

Where to Claim the Credit

You figure the credit on a worksheet included in the instructions for your return. You claim the credit in the "Tax and Credits" section of Form 1040 or the "Tax, Credits and Payments" section of Form 1040A; you cannot claim the credit if you file Form 1040EZ.

If you are eligible for the additional child tax credit, you figure this on Form 8812, *Additional Child Tax Credit*.

Earned Income Credit

Low-income taxpayers are encouraged to work and are rewarded for doing so by means of a special tax credit, called the earned income credit. The earned income credit is the second largest program, after Medicaid, that provides assistance to low-income people. The amount of the credit varies with income, filing status, and the number of dependents, if any. The credit may be viewed as a "negative income tax" because it can be paid to taxpayers even if it exceeds their tax liability. On 2014 returns, more than 28.8 million taxpayers claimed the earned income credit, totaling \$69.7 billion.

Benefit 

If you are a working taxpayer with low or moderate income, you may qualify for a special tax credit of up to \$6,269 in 2016. The amount of the credit depends on several factors, including your adjusted gross income, earned income, and the number of qualifying children that you claim as dependents on your return. Table 1.4 shows the maximum credit you may claim based on the number of your qualifying children, if any.

TABLE 1.4 Maximum Earned Income Credit for 2016

Number of Qualifying Children	Maximum Earned Income Credit
No qualifying child	\$ 506
1 qualifying child	3,373
2 qualifying children	5,572
3 or more qualifying children	6,269

The credit is “refundable” because it can be received in excess of the tax owed.

Conditions

To be eligible for the credit, you must have earned income from being an employee or a self-employed individual. The amount of the credit you are entitled to claim depends on several factors.

QUALIFYING CHILDREN

You may claim the credit even if you have no qualifying child. But you are entitled to a larger credit if you have one qualifying child and a still larger credit for 2 or more qualifying children.

To be a qualifying child, the child must:

- Be a qualifying child as defined earlier in the chapter under dependency exemption
- Be under age 19 or under age 24 and a full-time student or permanently and totally disabled
- Live in your U.S. household for more than half the year
- Qualify as your dependent if the child is married at the end of the year
- Be a U.S. citizen or resident (or a nonresident who is married to a U.S. citizen and elects to have all worldwide income subject to U.S. tax)

EARNED INCOME

Earned income includes wages, salary, tips, commissions, jury duty pay, union strike benefits, certain disability pensions, U.S. military basic quarters and subsistence allowances, and net earnings from self-employment (profit from your self-employment activities). Military personnel can elect to treat tax-free combat pay as earned income for purposes of the earned income credit.

Nontaxable employee compensation, such as tax-free fringe benefits or salary deferrals—for example, contributions to company 401(k) plans—is not treated as earned income.

To qualify for the maximum credit, you must have earned income at or above a set amount. Table 1.5 shows the earned income you need to obtain the top credit (depending on the number of your qualifying children, if any).

ADJUSTED GROSS INCOME

If your adjusted gross income is too high, the credit is reduced or eliminated. Table 1.6 shows the AGI phaseout range for the earned income credit. This depends not only on the number of qualifying children, if any, but also on your filing status, as shown in the table.

14 1001 DEDUCTIONS AND TAX BREAKS 2017**TABLE 1.5 Earned Income Needed for Top Credit in 2016**

Number of Qualifying Children	Earned Income Needed for Top Credit
No qualifying child	\$ 6,610
1 qualifying child	9,920
2 or more qualifying children	13,930

JOINT RETURN

If you are married, you usually must file a joint return with your spouse in order to claim an earned income credit. However, this requirement is waived if your spouse did not live in your household for the last 6 months of the year. In this case, assuming you paid the household expenses in which a qualifying child lived, you qualify as head of household and can claim the earned income credit (using “other taxpayers” limits on AGI).

Example

You are married and file a joint return. You and your spouse have 1 qualifying child. In 2016, if your AGI is less than \$23,740, your earned income credit is *not* subject to any phaseout. If your AGI is \$44,651 or higher, you cannot claim *any* earned income credit; it is completely phased out. If your AGI is between these amounts (within the phaseout range), you claim a reduced credit.

Planning Tips

The credit is based on a set percentage of earned income. However, you don't have to compute the credit. You merely look at an IRS Earned Income Credit Table, which accompanies the instructions for your return.

You can have the IRS figure your credit for you (you don't even have to look it up in the table). To do this, just complete your return up to the earned income credit line and put “EIC” on the dotted line next to it. If you have a qualifying child, complete and attach Schedule EIC to the return. Also attach Form 8862,

TABLE 1.6 AGI Phaseout Range for the Earned Income Credit in 2016

Number of Qualifying Children	Married Filing Jointly	Other Taxpayers
No qualifying child	\$13,820–20,430	\$ 8,270–14,880
1 qualifying child	\$23,740–44,846	\$18,190–39,296
2 qualifying children	\$23,740–50,198	\$18,190–44,648
3 or more qualifying children	\$23,740–53,505	\$18,190–47,955

Information to Claim Earned Income Credit after Disallowance, if you are required to do so as explained next.

Pitfalls

You lose eligibility for the credit if you have unearned income over \$3,400 in 2016 from dividends, interest (both taxable and tax-free), net rent or royalty income, net capital gains, or net passive income that is not self-employment income.

You lose out on the opportunity to claim the credit in future years if you negligently or fraudulently claim it on your return. You are banned for 2 years from claiming the earned income credit if your claim was reckless or in disregard of the tax rules. You lose out for 10 years if your claim was fraudulent. If you become ineligible because of negligence or fraud, the IRS issues a deficiency notice. You may counter the IRS's charge by filing Form 8862, *Information to Claim Earned Income Credit after Disallowance*, to show you are eligible.

If the IRS accepts your position and recertifies eligibility, you don't have to file this form again (unless you again become ineligible). For 2016 returns filed in 2017, the IRS is not permitted to issue tax refunds for the refundable earned income tax credit before February 15, 2017.

Where to Claim the Earned Income Credit

You can claim the earned income credit on *any* income tax return (Form 1040, 1040A, or 1040EZ) as follows: in the "Payments" section of Form 1040; the "Tax, Credits, and Payments" section of Form 1040A; or the "Payments and Tax" section of Form 1040EZ.

You can check your eligibility to claim the credit on Schedule EIC, Earned Income Credit, which must be attached to your return.

Dependent Care Expenses

Many taxpayers must pay for the care of a child in order to work. According to a 2015 report from the National Association of Child Care Resource and Referral Agencies, the annual cost of child care currently ranges from \$3,972 to \$17,062 per year. The tax law provides a limited tax credit for such costs, called the dependent care credit. The amount of the credit you can claim depends on your income. Or, if your employees help with child care costs, you may exclude the payments from your income.

Benefit

If you hire someone to care for your children or other dependents to enable you to work or incur other dependent care expenses, you may be eligible for a tax credit of up to \$2,100. More specifically, this credit is a percentage of eligible dependent care expenses (explained later). The credit percentage ranges from

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a low of 20% to a high of 35%. The maximum amount of expenses that can be taken into account in figuring the credit is \$3,000 for one qualifying dependent and \$6,000 for 2 or more qualifying dependents.

If your employer pays for your dependent care expenses, you may be able to exclude this benefit from income up to \$5,000.

Conditions for the Tax Credit

There are a number of conditions for claiming the dependent care credit; you must satisfy all 6 of them to claim the credit:

1. Incur the expenses to earn income.
2. Pay expenses on behalf of a qualifying dependent.
3. Pay over half the household expenses.
4. File a joint return if you are married.
5. Have qualifying expenses in excess of employer reimbursements.
6. Report information about the child care provider.

INCUR THE EXPENSES TO EARN INCOME

The purpose of the dependent care credit is to enable you to work. This generally means that if you are married, you both must work, either full time or part time.

However, a spouse who is incapacitated or a full-time student need not work; he or she is treated as having earned income of \$250 per month if there is one qualifying dependent or \$500 per month if there are 2 or more qualifying dependents.

Example

You are a single mother and a full-time student with 1 child. You are treated as having earned income of \$3,000 for the year ($\250×12). You can use this income in figuring your credit, even though you didn't actually receive this income.

PAY EXPENSES ON BEHALF OF A QUALIFYING DEPENDENT

This is for your child under the age of 13, your incapacitated dependent of any age, or your spouse who is incapacitated.

If your child has his or her 13th birthday during the year, you can take into account expenses incurred up to this birthday.

PAY OVER HALF THE HOUSEHOLD EXPENSES

You (and your spouse) must pay more than half of the maintenance expenses of the household.

FILE A JOINT RETURN IF MARRIED

Generally, to claim the credit you *must* file a joint return if eligible to do so. However, you can claim the credit even though you are still married if you live apart from your spouse for over half the year, you pay over half the household expenses for the full year, and your spouse is not a member of your household for the last 6 months of the year. In this case, you qualify to file as unmarried (single).

HAVE QUALIFYING EXPENSES IN EXCESS OF EMPLOYER REIMBURSEMENTS

Only certain types of child care expenses can be taken into account in figuring the credit. Qualifying expenses can be incurred in your home or outside the home (using a day care center). You cannot include amounts paid to you, your child who is under age 19 at the end of the year, your spouse, or any other person you can claim as a dependent.

EXAMPLES OF QUALIFYING EXPENSES

Babysitter

Day camp, including a specialty camp such as soccer or computers (but only the day cost of a sleep-away camp)

Day care center

Housekeeper (the portion of compensation allocated to dependent care)

Nursery school

Private school (The costs for first grade and higher do not qualify unless the child is handicapped, provided the child spends at least 8 hours per day in your home.)

Transportation, if supervised (so that it is part of care), such as to a day camp or after-school program not on school premises, but not the cost of personally driving a dependent to and from a dependent care center

You do not have to find the least expensive means of providing dependent care. For example, just because your child's grandparent lives in your home doesn't mean you must rely on the grandparent for child care; you can pay an unrelated person to babysit in your home or take your child to day care.

The expenses you incur for dependent care must be greater than any amount you exclude as employer-provided dependent care.

REPORT INFORMATION ABOUT THE DEPENDENT CARE PROVIDER

You must list the name, address, and employer identification number (or Social Security number) of the person you pay for dependent care. No employer identification number is required if payment is made to a tax-exempt charity providing the care.

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If the person has not completed Form W-4, *Employee's Withholding Allowance Certificate*, as your household employee, you can obtain the necessary information by asking the provider to complete Form W-10, *Dependent Care Provider's Identification and Certification*, or by looking at a driver's license, business letterhead, or invoice. This may seem like a lot of bother and formality for a baby-sitter, but if you want to claim the credit, you must comply with this information reporting requirement.

HOW TO FIGURE YOUR CREDIT PERCENTAGE BASED ON AGI

The amount of the credit you claim depends on your AGI. However, no matter how large your AGI, you are entitled to a minimum credit of 20% of eligible expenses. Table 1.7 shows you the maximum credit you may claim based on your AGI and number of dependents.

Example

You have 1 qualifying child and adjusted gross income of \$40,000. Your credit is 22% of your dependent care expenses up to \$3,000, for a top credit of \$660.

TABLE 1.7 Dependent Care Credit Limits

AGI	Credit Percentage	1 Dependent	2 or More Dependents
\$15,000 or less	35%	\$1,050	\$2,100
\$15,001–17,000	34	1,020	2,040
\$17,001–19,000	33	990	1,980
\$19,001–21,000	32	960	1,920
\$21,001–23,000	31	930	1,860
\$23,001–25,000	30	900	1,800
\$25,001–27,000	29	870	1,740
\$27,001–29,000	28	840	1,680
\$29,001–31,000	27	810	1,620
\$31,001–33,000	26	780	1,560
\$33,001–35,000	25	750	1,500
\$35,001–37,000	24	720	1,420
\$37,001–39,000	23	690	1,380
\$39,001–41,000	22	660	1,320
\$41,001–43,000	21	630	1,260
\$43,001 and over	20	600	1,200

Conditions for the Exclusion

Benefits must be provided by your employer under a written plan that does not discriminate in favor of owners or highly compensated employees (for example, top executives cannot obtain greater benefits than you). The dollar limit on this benefit is \$5,000 (or \$2,500 if you are married and file separately).

The same limits apply to a flexible spending arrangement (FSA), which is an employer plan to which you contribute a portion of your pay to be used for dependent care expenses. This salary reduction amount is *not* currently taxable to you; it becomes tax-free income that you withdraw from the FSA to cover eligible expenses.

Planning Tip

If you have the option of making salary reduction contributions to your company's flexible spending arrangement (FSA) for dependent care expenses, decide carefully on how much to contribute each month. You can use the funds in the FSA only for dependent care expenses; you cannot, for example, use any of the funds for your medical expenses or other costs. Any funds not used up by the end of the year (or within the first two and a half months of the next year if your employer has a grace period) are forfeited; they do not carry over.

Pitfall

If you qualify to receive an exclusion, you must reduce the amount of eligible expenses used in figuring the credit by the amount of the exclusion.

Example

You have 1 child and receive reimbursement from your employer's plan for the year of \$2,500. In figuring your tax credit, you can use only \$500 of eligible expenses (\$3,000 – \$2,500). In essence, once your exclusion is \$3,000 for 1 child or \$6,000 if you have 2 or more children, you cannot claim any tax credit.

If you participate in a dependent care FSA, distributions from the plan are treated as employer reimbursements. Like excludable benefits, distributions from FSAs reduce the amount of expenses you can use to figure the credit.

If you pay someone to care for your dependent in your home, you are the worker's employer. You are responsible for employment taxes. For more information about these employment taxes, see IRS Publication 926, *Household Employer's Tax Guide*, at www.irs.gov.

Where to Claim the Tax Credit or Exclusion

You figure the credit and the exclusion on Form 2441, *Dependent Care Expenses*. If you file Form 1040, the credit is then entered in the "Tax and Credit"

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section of your return. If you file Form 1040A, the credit is figured on Schedule 2 of the return. You may not claim the credit if you file Form 1040EZ.

If you owe employment taxes for a dependent care worker, you must file Form 1040 and complete Schedule H, *Household Employment Taxes*, which is attached to the return. You include employment taxes you owe in the “Other Taxes” section of your return.

Adoption Costs

Each year, more than 125,000 children are adopted in the United States (more than 30,000 of whom are from foreign countries in 2009, the most recent year for statistics), with costs as much as \$40,000 or more. Taxpayers who adopt a child may qualify for a tax credit. The amount of the credit may or may not fully offset actual costs for the adoption. If an employer pays for adoption costs, a worker may be able to exclude this fringe benefit from income.

Benefit

If you adopt a child, you may be eligible to claim a tax credit for the expenses you incur. The maximum credit is \$13,460 per child in 2016. The credit is 100% of eligible adoption expenses up to this dollar limit. If you adopt a child that the state has determined as having special needs (e.g., a medical condition), the credit is \$13,460 without regard to your actual adoption expenses. The credit, including one for a special needs child, is subject to income limits.

Example

In 2016, your income is \$100,000; you pay \$9,000 in attorney’s and adoption agency fees to adopt a child who is not a special needs child (the adoption becomes final in 2016). You can claim a tax credit of \$9,000 (100% of your eligible costs that do not exceed \$13,460).

If your employer pays or reimburses you for adoption expenses, you may exclude this benefit from your income; it is tax free to you if you meet eligibility conditions. The exclusion has the same dollar limit and income limits as the credit.

If a tax-exempt organization makes a payment to help pay adoption costs, the payment is not taxable. The payment is viewed as a gift to the recipient.

Conditions

To claim the adoption credit or exclusion, 2 key conditions apply:

1. You must pay qualified adoption expenses.
2. Your modified adjusted gross income cannot exceed a set amount.

There is an additional condition for married persons; they must file jointly unless they are legally separated or live apart for the last 6 months of the year. This requirement applies even if only one spouse is adopting a child.

The determination of whether a child is a special needs child must be made by the state; a taxpayer cannot make this call on his or her own.

QUALIFIED ADOPTION EXPENSES

Qualified expenses include any reasonable and necessary expenses related to the adoption.

EXAMPLES OF QUALIFIED ADOPTION EXPENSES

- Adoption agency fees
- Attorney's fees
- Court costs
- Travel expenses while away from home (including meals and lodging)

Nonqualifying expenses include those related to your adoption of your spouse's child, expenses related to a surrogate parenting arrangement, expenses paid for adopting your spouse's child, expenses paid using funds received from a government program, and expenses that violate the law.

MODIFIED ADJUSTED GROSS INCOME LIMIT

To be eligible for the full credit or the exclusion, your modified adjusted gross income in 2016 cannot exceed \$201,920. If your MAGI is over \$241,920, the credit is completely phased out.

Example

You adopt a child in 2016 and your MAGI is \$221,920. You can only claim a credit of up to \$6,730; half of the credit limit is phased out because of your MAGI.

Modified adjusted gross income for this purpose is AGI increased by the foreign earned income exclusion; the foreign housing exclusion or deduction; and the exclusion for income from Guam, American Samoa, Northern Mariana Islands, or Puerto Rico.

Planning Tips

The amount of the adoption credit cannot be more than your tax liability for the year. Tax liability for this purpose means your regular tax, plus your tentative alternative minimum tax (without regard to the foreign tax credit), dependent care credit, credit for the elderly or disabled, education credit, child tax credit, or mortgage interest credit if any.

TABLE 1.8 Year to Claim the Credit for Adoption of a U.S. Citizen or Resident Child

When You Pay Expenses	When You Claim Credit
Any year before year the adoption becomes final (or falls through)	Year after year of payment
Year adoption becomes final (or falls through)	Year adoption becomes final (or falls through)
Any year after year adoption becomes final (or falls through)	Year of payment

However, if the credit exceeds your tax liability, you can carry the excess credit forward for up to 5 years.

If your employer has an adoption assistance program but you aren't entitled to some or all of the exclusion (e.g., your MAGI is too high or your expenses exceeded the dollar limit), plan to pay tax on the amount your employer pays or reimburses you. The employer is *not* required to withhold income tax on these payments. Employer-paid expenses are reported on your Form W-2.

Obtain a taxpayer identification number for the child if he/she does not have one. Use Form W-7A, *Application for Taxpayer Identification Number For Pending Adoption*, to obtain a temporary tax ID for a child in a domestic adoption who does not have or is unable to obtain the child's Social Security number.

Pitfall

The year for which you are entitled to claim the credit depends on the type of child you are adopting.

CHILD WHO IS A U.S. CITIZEN OR RESIDENT

If you adopt or are adopting a child who is a U.S. citizen or resident, use Table 1.8 to see the year for which to claim the credit for payments you make.

FOREIGN CHILD

You can take the credit only if the adoption becomes final. Use Table 1.9 to see the year in which to claim the credit.

Where to Claim the Adoption Credit or Exclusion

You figure the adoption credit on Form 8839, *Qualified Adoption Expenses*, which is attached to your return. You can claim the credit only if you file Form 1040 or Form 1040A; you cannot claim the credit if you file Form 1040EZ.

TABLE 1.9 Year to Claim the Credit for Adoption of a Foreign Child

When You Pay Expenses	When You Claim Credit
Any year before year adoption becomes final	Year adoption becomes final
Year adoption becomes final	Year adoption becomes final
Any year after year adoption becomes final	Year of payment

To claim the credit, you must retain certain documents; they do not have to be attached to the return.

- For U.S. adoptions, attach a copy of the adoption order or decree.
- For adoptions finalized abroad, include the child's Hague Adoption Certificate, an IH-3 visa, or a foreign adoption decree translated into English. If the child's country of origin is not a party to the Hague Convention, then attach a copy of the translated decree or an IR-2 or IR-3 visa.
- If you adopt a special needs child, also attach the state determination of the child's special needs status certificate so you can claim the full \$13,190, regardless of the adoption costs you paid.

Example

In 2015, you start the adoption process, hiring a lawyer and paying a retainer of \$3,000. In 2015, the lawyer helps you work with an authorized adoption agency to which you pay a fee of \$10,000 to adopt your daughter, a U.S. resident. The child is placed with you at that time. In 2016, you pay the lawyer an additional \$4,000 and the adoption becomes final in this year. You may *not* claim any credit in 2015. In 2016, you may claim a credit up to \$13,460, comprised of \$13,000 [retainer and adoption fee] paid in 2015 and \$460 of the \$4,000 additional attorney's fee paid in 2016. The excess expenses of \$3,540 [\$4,000 – \$460] are not carried over and cannot be used in the future.

If your employer paid or reimbursed you for qualified expenses, you must also complete this form to figure excludable benefits.

Foster Care

Taxpayers who care for children in foster care and receive funds for expenses may not be taxed on the funds. Instead, they may be able to exclude the payments they receive from income.

Benefit

Exclusion for foster care payments. If you receive foster care payments to care for a child placed with you by a state or local agency or a tax-exempt foster care placement agency, you are not taxed on the payments. They are fully excludable; there is no dollar limit.

Qualified payments include payments for the provision of foster care. They also include difficulty-of-care payments to account for the additional care required for a child with physical, mental, or emotional handicap. Payments

under a state Medicaid Home and Community-Based Services Waiver (Medicaid waiver) program are treated as difficulty-of-care payments.

However, the exclusion for foster care payments is limited to payments received for 5 qualifying individuals who are over age 18. The exclusion for difficulty-of-care payments is limited to payments received for 10 qualifying individuals who are over age 18. There are no limits on the number of children age 18 or under for whom the exclusion may be claimed.

Deduction for out-of-pocket costs. See Chapter 6.

Condition

Foster care payments include only those made by a state or local government or qualified foster care placement agency for the care of a qualified foster child or a difficulty-of-care payment. Also, you and the foster child must live in the same home.

Planning Tip

If you are a foster care parent dealing with a private agency, make sure the placement entitles you to exclude payments received for the care of the child.

Pitfalls

Payments received from private agencies that are not tax-exempt entities, even though licensed by the state, are not excludable from income.

Payments made to a child's biological parent cannot be excluded, even if labeled "foster care payment" because such parent is never a foster parent.

Where to Claim the Exclusion

Foster care payments are not reported on the return if they are excludable. If you care for more than the allowable number of children over age 18, you must include the payments in income. Report this as "other income" on your return.

Child Support

Divorced or separated parents may be ordered by a court to make support payments for a child of the marriage. Even an unwed parent may be instructed to support his or her child. The recipient of child support payments, typically the parent with whom the child resides, is not taxed on these payments. (The parent making the payments cannot deduct them, but paying child support may entitle the parent to other tax write-offs discussed throughout this chapter, such as the dependency exemption.)

Benefit

Child support payments are not taxable to the child, nor to the parent who receives them on behalf of the child. There is no dollar limit to this benefit.

Conditions

Payments for child support should be fixed. If they are set by a decree of divorce or separate maintenance or a separation agreement, they are considered to be fixed.

In addition, if payments made to a parent will be reduced or terminated upon a contingency related to the child, then those payments are treated as being fixed for child support. Contingencies for this purpose include:

- Reaching the age of majority (generally age 18 or 21, depending on the law in your state)
- Leaving school
- Marrying
- Entering military service
- Moving out of the custodial parent's home
- Starting to work and/or attaining a set income level

Planning Tip

If a parent is required to pay both alimony and child support but makes a single payment that is less than the total amount due, the first dollars are considered tax-free child support.

Example

Ed owes his former spouse \$1,000 each month to cover alimony of \$600 and child support of \$400. In March 2016, Ed pays only \$500. Of this amount, \$400 is treated as child support; \$100 is treated as alimony.

Pitfalls

The parent who makes child support payments cannot deduct them. They are not considered to be part of deductible alimony payments (explained in the next section).

If a reduction in child support payments to a parent is not specifically tied to the child's age of majority but is scheduled to occur within 6 months before or after such date, the reduction is treated as if it was tied to the child. This means that the amount subject to reduction is viewed as child support and not as deductible alimony. The same rule applies if you are making payments on behalf of more than one child and there are at least 2 reductions, each of which is within a year of a child's reaching the age of majority.

If you are due a refund of federal income tax because you overpaid it through withholding or estimated taxes, you won't receive it if you are delinquent on your child support payments. The IRS is authorized to divert your refund to the

parent owed the child support payments as long as the state provides notice to you and a procedure you can follow to contest this action.

Where to Claim the Exclusion

Child support payments received need not be reported on the return.

Alimony

Taxpayers who are required by a court to make payments to a spouse or former spouse can deduct such payments. The payments may be called alimony, support, or spousal maintenance, depending on state law (called “alimony” here for convenience). The tax law, in most cases, imposes symmetry on the treatment of alimony so that the government effectively comes out even: the spouse receiving the payments reports them as income while the spouse making the payments gets to deduct them.

Benefit

If you make payments to a spouse or former spouse for alimony, support, or spousal maintenance, you can deduct the payments if certain conditions are met. There is no dollar limit on this deduction. The deduction is claimed as an adjustment to gross income; you do not have to itemize your other deductions to write off alimony payments you make.

Conditions

There are 4 conditions that must be met for payments made to a spouse or former spouse to be considered alimony:

1. Amounts must be paid pursuant to a legal requirement, such as a court decree.
2. Payments must be made in cash.
3. You must live apart from your spouse or former spouse.
4. Your responsibility to make payments must terminate on the death of your spouse or former spouse.

Typically, alimony that is deductible by the payer is taxable to the recipient—the government effectively nets no additional tax revenue from the arrangement. But this symmetry is not required. If you meet all of the conditions, you can deduct your alimony payments even if your former spouse is not required to pay tax on them (for example, your former spouse lives abroad where alimony is exempt income).

PAYABLE UNDER A COURT DECREE

You can't deduct alimony if you voluntarily make payments. You must either be ordered to do so under a decree of divorce, legal separation, or support or agree to make payments under a written separation agreement.

If the marriage is annulled and you are ordered to make payments, they can be treated as alimony if the other conditions are satisfied.

CASH PAYMENTS

You can deduct only payments made in cash. But you don't necessarily have to make these payments directly *to* your spouse or former spouse. Payments made *on behalf of* your spouse or former spouse qualify for the deduction if required by the divorce decree or separation agreement. For example, if you are ordered to pay your former spouse's rent with a check directly to the landlord, you can treat the payment as alimony if the other conditions are met.

If you continue to own the home in which your former spouse resides (i.e., own it by yourself or jointly with your former spouse) and you pay the mortgage and other expenses, only some of these expenses qualify as deductible alimony—even if you are required to make the payments under the terms of a divorce decree or separation agreement. If you own the home, you benefit from the payment of the mortgage, real estate taxes, and other maintenance on the property and cannot deduct these payments. If you own the home jointly, only one-half of your payments can be treated as alimony because only one-half benefits your spouse or former spouse. (Of course, you can deduct mortgage interest and real estate taxes as itemized deductions as explained in Chapter 4.)

LIVING APART

You and your spouse or former spouse must not live in the same household. This means separate residences; merely having separate bedrooms in the same home is not good enough for payments to be treated as alimony.

However, payments made while you are preparing to leave can be deducted. There is a one-month limit so that only payments made within one month prior to your departure can be treated as alimony. If it takes you longer to move out, your earlier payments are not deductible.

PAYMENT RESPONSIBILITY ENDS ON DEATH

Your responsibility to make payments to your spouse or former spouse must end if that person dies. If your obligation to make payments continues beyond the recipient's death (for example, you must continue to pay until total payments reach a set amount), you cannot treat *any* of the payments as alimony (even those made before death).

Generally, the divorce decree should state that your obligation to make payments ends on the recipient's death. But this isn't necessary as long as this condition is part of the law in your state.

The fact that your estate continues to be liable for payments after your death does not prevent you from treating your payments as alimony.

Planning Tip

Don't voluntarily increase your payments. If you want to ensure that increased payments qualify as deductible alimony, you need to amend the court order or separation agreement to incorporate the change.

Pitfalls

Payments made to someone who was never legally your spouse cannot be treated as alimony. For example, if you make payments to a domestic partner, you cannot deduct them even though they otherwise have all the earmarks of alimony.

Property settlements are not deductible. If you make payments that decline by more than \$15,000 in the second or third year, in the third year, you may lose some of the deductions you've already claimed. This reduction is viewed as front-loading—trying to make a property settlement appear to be alimony so that you can deduct it (a property settlement isn't deductible).

In effect, deductible payments in year 1 and year 2 are recaptured in the 3rd year if payments decline by too much. The recipient removes them from income and you lose your deductions, and this is reported on the return for the third year (you don't go back and amend the returns in years 1 and 2).

Where to Claim the Deduction

The deduction for alimony payments is claimed on Form 1040 in the section labeled "Adjusted Gross Income." You cannot deduct alimony if you file Form 1040A or Form 1040EZ.

There is no separate form or schedule to complete when deducting alimony. However, you *must* include the recipient's Social Security number on your return (to allow the IRS to cross-check whether the recipient reported the alimony as income).

ABLE Accounts

If you have a disabled child or are under age 26 and meet certain eligibility conditions, you can have a special savings account that generally does not adversely impact eligibility for means-tested government programs (e.g., Medicaid). The account can be used on a tax-free basis for various disability-related expenses (including funeral and burial costs). See details in Chapter 2.