



Children:

Exemptions, Credits and Income Shifting Techniques

GAINER DONNELLY & DESROCHES

Children: Exemptions, Credits And Income Shifting Techniques

The addition of children to your family not only brings joy to your life, but also gives you some significant tax savings. Since children invariably mean added expenses, the Tax Code gives you a break in the form of exemptions, tax and childcare credits and a credit for adoption expenses. Even with the so-called kiddie tax, shifting income to your children can still be an effective strategy to decrease taxes. This guide highlights the child tax breaks and, in conjunction with your tax advisor, gives you some suggested strategies for tax planning.

The *Working Families Tax Relief Act of 2004 (WFTRA)*, created a new, uniform definition of child and rewrote the definition of dependent. Dependents are characterized as either qualifying children or qualifying relatives. For children, the new law eliminates the traditional gross income test and redefines the traditional support test.

Your children include your:

- Natural children;
- Step-children;
- Adopted children; and
- Eligible foster children

Qualifying as a dependent

Some tests must be satisfied before an exemption for a dependent is allowed:

- (1) **Relationship:** A qualifying child must be your natural, step, adopted, or eligible foster child or a descendent of your child or your sibling or a descendent of your sibling. Step-siblings and their descendents also qualify.

Example. Aaron's household includes his son, Barry, his son's daughter, Connie, his sister, Danielle, and his nephew Eduardo. All of these people satisfy the relationship test. Barry is Aaron's son; Connie is his grandchild; Danielle is his sibling; and Eduardo is a descendent of his sibling.

- (2) **Age:** Generally, an individual must be under age 19 to be treated as a child. However, the age limit is higher (24) for young people who are full-time students. There is no age test for people who are permanently and totally disabled.

- (3) **Abode:** This test asks where does the child live? To qualify, a child must live with you for more than half of the year.
- (4) **Citizenship:** The child must be a citizen of the U.S. or a resident of Canada or Mexico.

Comment. If an individual does not qualify as a child, for example, because of the age limit, they may be treated as a dependent if he or she is a qualifying relative. The tests for a qualifying relative are similar to the tests for a qualifying child but with some important differences, especially about support.

Note: Following the devastation of Hurricane Katrina in the fall of 2005, Congress passed the Katrina Emergency Tax Relief Act of 2005 (KETRA), which included a provision allowing good Samaritans who housed Katrina victims to claim a deduction akin to the personal exemption for the victims housed. If you housed such victims, you may be able to deduct up to \$2,000 from your taxable income—\$500 per evacuee—if you housed the evacuee for 60 consecutive days in your principal residence.

Exemptions

In addition to a personal exemption for yourself (and your spouse if filing a joint return), you are allowed an exemption of \$3,300 for each dependent for 2006. To maximize the value of this exemption, you have to understand who qualifies as a dependent.

Caution. If you can claim your child as a dependent on your return, your child may not claim his or her own personal exemption on his or her return.

Caution. No dependency exemption is allowed for your child unless you include the child's Taxpayer Identification Number (TIN) on your return.

Adoption

A legally adopted child or a child placed in your home for adoption by an authorized agency is considered to be your child by blood.

If you are in the process of a domestic adoption, have custody of the child pending the final adoption and provide enough financial support during the year, you may claim a dependency exemption for the child.

Caution. If you are adopting a child and do not have a TIN for the child, you must apply for an adoption taxpayer identification number (ATIN). An ATIN is a temporary TIN assigned by the IRS. When the adoption becomes final, you must apply for a Social Security number (SSN) for the child. When assigned, the SSN, rather than the ATIN, is used as the child's TIN.

Divorced parents

If you are a divorced parent, you probably already know what a headache the dependency exemption can be. Just because you have custody of a child doesn't automatically mean you can claim him or her as a dependent. You can relinquish your exemption to your ex-spouse. The rules are very

complicated and you need professional advice before agreeing to relinquish your dependency exemption.

Exemption phaseout

The dependency exemption may be reduced or eliminated depending on your income. The exemption is reduced by two percent for each \$2,500 or fraction thereof by which AGI exceeds a threshold amount.

The 2006 threshold amounts are:

- (1) \$225,750 for joint filers or a surviving spouse;
- (2) \$188,150 for a head of household;
- (3) \$150,500 for single taxpayers; and
- (4) \$112,875 for married persons filing separately.

Child Tax Credit

If you have a child under the age of 17, you may be entitled to a \$1,000 child tax credit. The credit begins to phase out when modified adjusted gross income (AGI) reaches \$110,000 for married couples filing jointly, \$55,000 for married couples filing separately, and \$75,000 for singles. The credit is reduced by \$50 for each \$1,000 of modified AGI above the thresholds. The child tax credit amounts are not inflation indexed.

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Planning tip. Generally, a qualifying child must not have provided more than one-half of his or her own support. Support includes more than just giving your dependent food and shelter. Mental and dental care, education and recreational activities are just some of the many examples of support.

Comment. In 2003, Congress raised the child tax credit to \$1,000. This was very popular and in 2004, Congress voted to keep the credit at \$1,000 through 2010.

Who qualifies?

WFTRA changed the traditional definition about who qualifies for the child tax credit. A qualifying child for the child tax credit is your:

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

The new definition uses the same relationship test that the dependency exemption uses.

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A qualifying child must be your natural, step, adopted, or eligible foster child or a descendent of your child or your sibling or a descendent of your sibling. Step-siblings and their descendents also qualify.

A qualifying child also must live with you and must not have provided more than one-half of his or her support.

Amount of credit

The child tax credit is \$1,000 per qualifying child, effective through 2010.

Caution. The age cut-off for the child tax credit is lower than for the dependency exemption. A qualifying child for the child tax credit must be under age 17.

Childcare

Although you can't deduct what you pay for child care, you may be eligible for some child care tax breaks.

Childcare credit

If you pay someone to watch your under-age-13 child so that you can be gainfully employed, you can get a childcare tax credit. You must be eligible to claim a dependency exemption for the child. The maximum credit is \$1,050 if one child is cared for and \$2,100 if care is provided for two or more children.

Caution. Any employer-provided assistance reduces the credit on a dollar-for-dollar basis.

If one parent works at home, no babysitting or other child care costs are eligible for the credit. If the stay-at-home parent goes to work part-time, however, childcare costs that enable the parent part-time work are eligible.

Out-of-home care

A restriction applies to employment-related expenses that are incurred for services outside your household. These expenses count toward the credit only if incurred for the care of:

- A dependent who is under the age of 13 and for whom you are entitled to a dependency exemption; or
- Any other qualifying individual who regularly spends at least eight hours each day in the taxpayer's household.

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

The credit equals 35 percent of eligible expenses for individuals with adjusted gross income

(AGI) of \$15,000 or less. The percentage decreases by one percent for each additional \$2,000 of AGI until it becomes a flat 20 percent for individuals with AGIs of more than \$43,000.

Eligible expenses cannot exceed \$3,000 for one child or \$6,000 for two or more children.

Employer-provided assistance

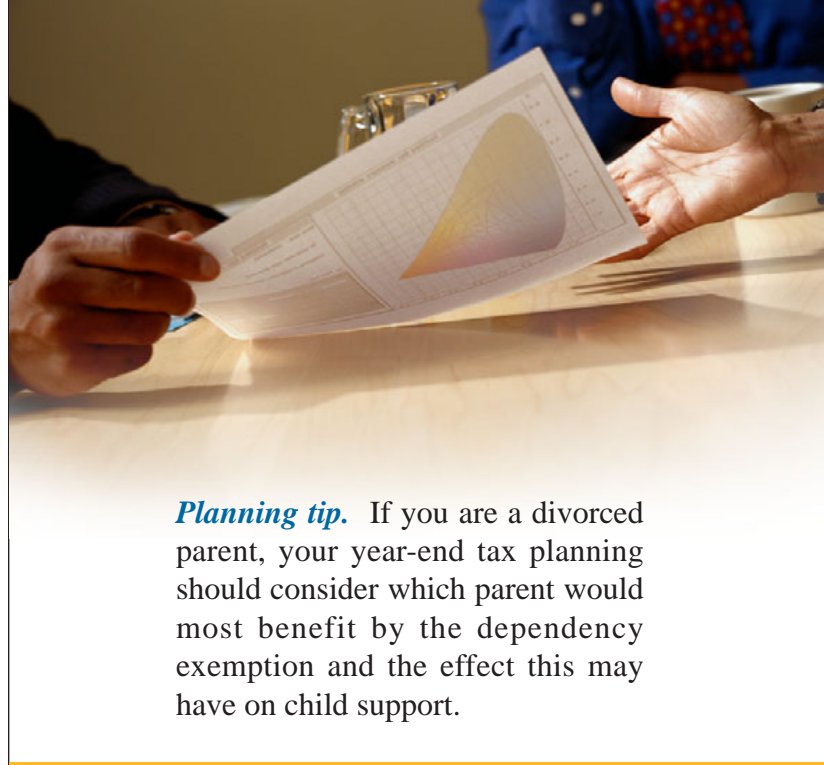
If your employer provides child or dependent care, you may be eligible for some special tax incentives.

Up to \$5,000 of dependent-care assistance that you receive from an employer-paid child care program is completely tax-free.

If your employer maintains a cafeteria plan that lets employees choose between receiving fixed amounts of cash or qualified tax-free benefits, the amount you elect to receive for childcare assistance under the plan is tax-free if it doesn't exceed \$5,000.

Your employer may maintain a flexible spending account (FSA) that allows you to set aside part of your earnings in an account for childcare expenses. You use pre-tax dollars for child-care expenses.

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Planning tip. If you are a divorced parent, your year-end tax planning should consider which parent would most benefit by the dependency exemption and the effect this may have on child support.

Example. You and your spouse have two children who attend day care. If you contribute \$5,000 to an FSA and are in the 28% tax bracket, you will save \$1,400 ($\$5,000 \times 28\%$) in tax. Furthermore, you get an additional tax savings of \$383 ($\$5,000 \times 7.65\%$) because you don't have to pay the 7.65% Social Security tax on amounts contributed to an FSA.

Adoption Expenses

Over the past 20 years, Congress has added some very generous tax incentives for people who adopt children. If you adopt a "special needs" child, you are eligible for enhanced tax breaks.

Adoption Credit

You may claim a tax credit of up to \$10,000 (plus an annual inflation factor) for qualified adoption expenses. The amount for 2005 was \$10,630. In 2006, you may claim a

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credit of \$10,960. Qualifying expenses include legal and administrative fees. The credit is not affected by your marital status and applies to each adoption. If you adopt a special needs child after 2006, you may claim a \$10,960 credit even if your actual expenses are less than that amount. Special rules may apply to foreign adoptions.

The credit is phased-out for people with incomes between certain levels. For 2006, those levels are \$164,410 and \$204,410.

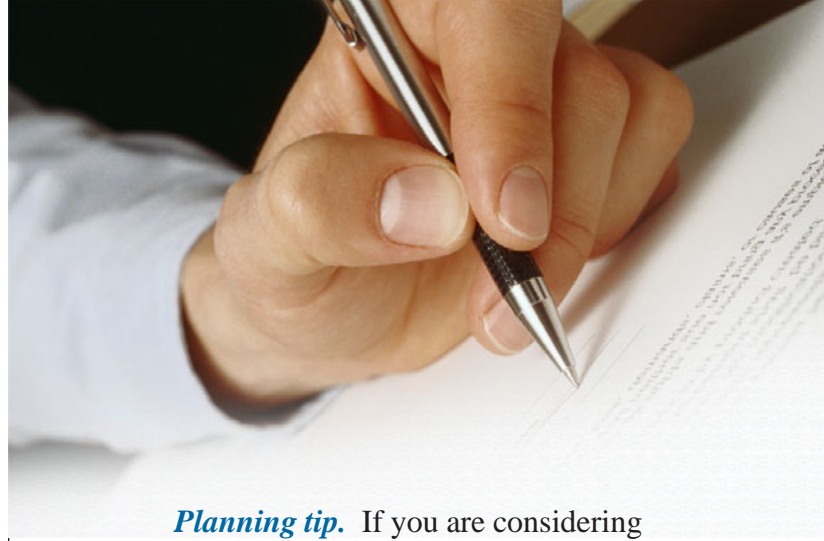
You may claim the adoption credit against your regular and alternative minimum tax (AMT) liability. Although your credit may not reduce your regular and AMT liability below zero, you can carry forward any unused credit for up to five years.

Shifting Income To Your Kids

Chances are that you are in a higher tax bracket than your children. If so, you may be able to save taxes by shifting income to children, even if they are under age 14 and subject to the “kiddie tax.”

Kiddie tax

The kiddie tax took away a major benefit of shifting large amounts of income to children, by taxing the



Planning tip. If you are considering adopting a child, check if your employer provides any adoption assistance. You can exclude up to \$10,000 from an employer adoption assistance program.

child’s unearned income at the parents’ higher rate. The kiddie tax separates and taxes a child’s unearned income in three ways:

- Unearned income up to \$850 is not taxed;
- Unearned income between \$851 and \$1,700 is taxed at 10 percent; and
- Unearned income over \$1,700 is taxed at the parents’ rate.

The kiddie tax is designed to reach investment income, such as dividends, interest and gains from the sale or exchange of property. It also applies to income that is not earned income, including Social Security and pension benefits.

The age cap on the kiddie tax allows you to plan in several ways:

- First, you can expect the income on the property transferred to eventually be taxed at a lower rate than if you kept it.
- Second, you can transfer property that will produce the most income only starting after the year in which the child reaches 13. This may be accomplished, for example, if you follow special rules concerning U.S. Series EE savings bonds, under which interest income can be deferred until redemption or maturity. You can also transfer property that has built-in or expected appreciation and that does not generate any taxable income until it is sold, such as non-dividend paying stock or land.
- Third, you also get a modest savings because the first \$850 (for 2006, as adjusted for inflation) based on the standard deduction for a dependent is usually tax-free and the next \$850 is taxed at 10%.

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Planning tip. Payments made to relatives for child care qualify for the credit if the relative is not your dependent or spouse. For example, if Alec pays \$500 of employment-related expenses to his mother for the care of his five-year-old son, and he cannot claim a personal exemption for his mother, he is allowed a credit based on the amounts paid to his mother for the care of his child. His mother, however, must report the \$500 as taxable income.

Transferring capital assets to children also makes sense as a long term investment, or even as a relatively short-term holding if a child is nearing age 14. Securities and other capital assets can be transferred annually to a child with no gift tax consequences if fair market value is not greater than \$12,000 (\$24,000 if a split-gift with a spouse is made).

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Appreciation is not taxed until the asset is sold. If it is sold after the year in which the child reaches 13, the capital gain is taxed under the unmarried single tax bracket category.

Example. The transfer of an asset to a child that produces \$1,500 in income to the child would save a family in the 35% tax bracket \$450.

Caution. The alternative minimum tax (AMT) may be imposed on the income of a child under the age of 14. For purposes of determining the child's AMT liability, there is an exemption for the sum of the child's earned income plus \$6,050.

Put the kids to work

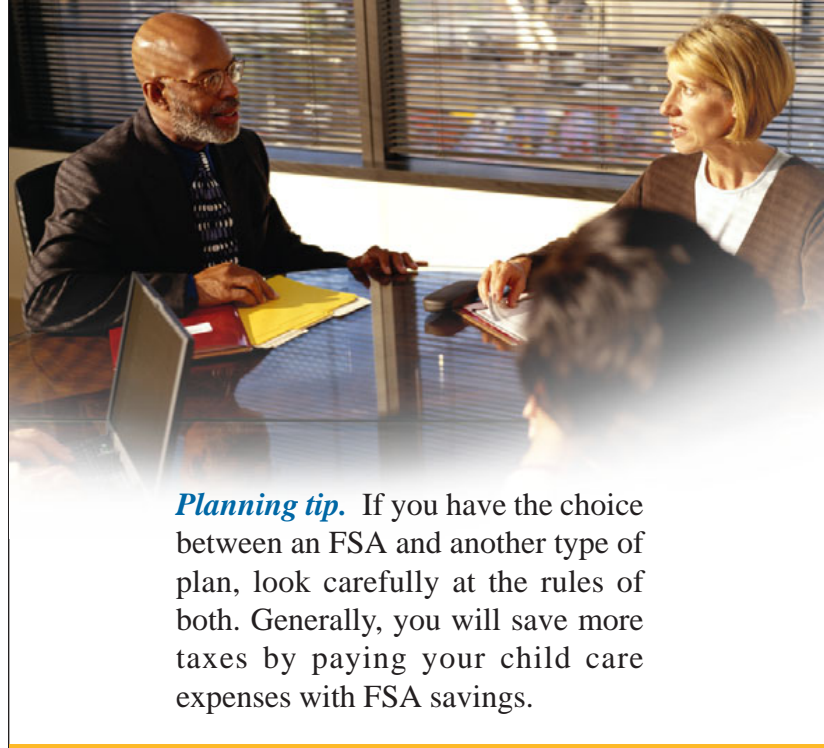
If you operate your own business, you may want to hire your children. Earned income is not subject to the kiddie tax, so you can shift funds to family members in lower tax brackets, take advantage of your child's standard deductions and to get work done in the process. If the compensation is reasonable, you may deduct it as a business expense.

Caution. If a child's earnings are used to discharge your support obligation, then you may be taxed on the earnings.

To show that compensation was reasonable, you must maintain business records of hours worked and tasks performed. Salary payments should be made directly to your child. Avoid indirect payments, such as payment to a music teacher, on behalf of your child.

Conclusion

The first step to taking full advantage of the child tax incentives is to understand their eligibility



Planning tip. If you have the choice between an FSA and another type of plan, look carefully at the rules of both. Generally, you will save more taxes by paying your child care expenses with FSA savings.

requirements. Your tax advisor will help you understand the definitions and complex terminology.

Once you've determined if you're eligible for a child tax credit or deduction, you need to understand the mechanics of the tax incentive so you can maximize its value. Some credits and deductions are adjusted for inflation. Others have important income phaseout limitations.

Shifting income to your children can generate significant tax savings...so long as your expectations are realistic. The kiddie tax is often a barrier to tax savings but, with advance planning, it is an important part of a larger tax strategy.

Your tax advisor can start work today on a tax strategy using all or some of the child tax incentives. Talk to him or her and don't lose out on these valuable child tax breaks.