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April 2002 - Claiming Tax Credits for Your Children (And a News Flash on The Latest New Tax Law Passed in March 2002)

This is the concluding article of a series of three on family tax issues. Previous articles in the series covered rules for claiming dependent exemptions and the head of household filing status. This article will discuss the rules for claiming the regular and additional child tax credit, the child and dependent care credit, and the earned income credit. These rules have similarities to the rules for claiming dependent exemptions but are more restrictive than those rules. The credits can reach several thousand dollars and are certainly worth the effort to claim, however care should be taken to properly follow the rules to avoid unwanted correspondence with the IRS and unnecessary delays in receiving your tax refunds.

A large new tax law passed Congress in March which could affect some of you finalizing your tax returns before the April 15 deadline, so I will also give some information in this article that will help you know if you need to make any last minute decisions to take advantage of the new law before filing.

The Child Tax Credit.

A child tax credit of \$600 can be claimed on 2001-04 tax returns for each child, stepchild, or foster child under age 17 that you can claim the dependent exemption for. The age is determined as of December 31 each year. The amount of the credit will increase beginning in 2005.

The credit begins to be phased out above modified adjusted gross income (MAGI) of \$55,000 if married filing separately, \$75,000 for single or head of household, and \$110,000 for married filing jointly. To determine the income at which phase out is complete, take the total amount of child tax credit, multiply by 20, and add to the income at which the phase out begins. For example, if you have two qualifying children your total child tax credit is \$1,200, which you multiply by 20 (to get \$24,000). If you are head of household, you would add \$24,000 in this example to \$75,000 to find that \$99,000 is the MAGI level at which the credit is completely phased out.

Divorced parents will want to consider these limits in choosing which of them will be able to claim the dependent exemption to make sure this credit is not wasted.

Generally the child tax credit is limited to the amount of income tax (not including self employment tax). For example if the income tax on your return is \$500, you would usually get just the \$500 credit that would bring your tax to zero, not the full amount of the credit you would otherwise be entitled to. There are two exceptions that allow the full credit, even when the tax is less. The first exception allows the credit to exceed the tax by 10% of the amount of earned income (from wages or self employment) that exceeds \$10,000. Thus, if earned income is \$30,000, you could claim up to \$2,000 of child tax credit beyond the point at which your tax is zero. This is a new provision for 2001 and is giving nicely increased refund checks to the people who qualify for this exception. The second exception is called **the Additional Child Tax Credit** and has been continued from past years. The additional child tax credit applies only to people with three or more children, and allows child tax credit to be paid up to the amount of social security tax plus the amount of income tax. Form 8812 must be filed with your tax return to claim the additional child tax credit.

The Child and Dependent Care Credit.

This credit is claimed on Form 2441 for day care expense for your dependent children under age 13 or for any dependent or your spouse that is physically or mentally unable to care for him- or herself. The day care expense must have been incurred so that you could work or attend school.

The credit varies between 20 and 30 percent of the care expense paid, depending on income. It is also limited to \$480 for one dependent and \$960 for more than one dependent cared for. The credit will increase for 2002 returns to up to 35 percent of care expense paid and up to \$600 for one dependent and \$1200 for multiple dependents.

To claim the credit, you must have the name, address, and social security number of each care provider used during the year. This prevents many people from claiming this credit, since some care providers refuse to disclose this information. The irony of that situation is that there are many special deductions available to those operating child care businesses in their homes. In many cases these deductions would offset the income they are hoping to avoid claiming on their returns.

A side note for those who had all or part of their income in California. You may qualify for an additional state child and dependent care credit, one additional requirement is that you must have the care provider's phone number in addition to the information required for federal.

The Earned Income Credit.

This credit is designed to give some relief and incentive to work to those with low incomes, particularly those with children. It is one of the few fully refundable credits, meaning it can be claimed even when income tax is zero. For 2001, the maximum credit has been increased significantly to \$376 for those without children, \$2,506 for those with 1 child, and \$4,140 for those with 2 or more children. The credit depends on adjusted gross income and earned income, has phase out levels, and is denied to those with investment income (including S corporation income) above \$2,400. Rules also apply in multiple child custody situations.

The purpose of mentioning the earned income credit in this article is simply to let you know of the increase in the credit this year, and to encourage you to get help either from a professional or one of the volunteer organizations such as VITA to help you determine what you actually qualify for. Form 8867 provides a useful checklist for qualifying requirements if you do want to try to figure this out yourself.

Headlines of the March 2002 Tax Law Changes

I will cover these changes more thoroughly next month, but for those claiming depreciation for tools or equipment purchased after September 11, 2001 either for their employment or for their business, there are changes that affect the 2001 returns you are filing right now. If you have already filed, you will want to consider amending, and if you have not, you may want to get an extension past April 15 so that you can fully take advantage of the increased writeoffs in this new tax law.

The information in this article is intended to inform you of some of the income tax rules concerning claiming the various tax credits available for your children and other family members. It is not intended to give you specific advice for your personal situation. If you need such advice, please contact a qualified professional! Please call or e-mail me (dougbeecher@yahoo.com) if you are a prospective new client and would like a free initial 30-minute consultation to discuss your personal situation and how the tax laws might benefit you.

If you have a question you'd like to have answered in a future article, please contact me.