Children and Family Finances -- Tax Benefits

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Raising a child involves a lifetime of responsibilities but includes many rewards. Among those responsibilities is a financial one - the cost of raising a child. It is a good idea to consider this before the baby arrives. Knowing the potential costs, your family may prepare by adjusting your monthly budget and begin setting aside money in your spending plan. That way, when the child arrives, the financial impact will be minimized.

This series of fact sheets is designed to help your family understand the obvious and hidden costs of raising a child. According to the United States Department of Agriculture (USDA), there are many things to consider-including: housing, food, transportation, clothing, health insurance, child care, education, and miscellaneous goods and services. This publication focuses on these categories with exercises to help you become more prudent in making the financial decisions for your household.

Tax Benefits for Raising a Child

For basic information on federal income taxes see Internal Revenue Service (IRS) Publication 17. You can order or view this free publication on the IRS web site http://www.irs.gov.

Personal Exemption

Regardless of when your child is born during the year, you will receive an additional personal exemption at tax time. In 2009, each personal exemption will reduce your taxable income by $3,650. For parents to claim the exemption, the child must have a Social Security number, so apply for one as soon as your child is born. You can apply at any Social Security office or you can download the form to apply for a number at the Social Security Administration web site, http://www.ssa.gov. Some hospitals will give you a form in their “welcome baby” materials.

Tax Credits

Having a child may also qualify you for certain tax credits. Tax credits are more advantageous than deductions. A tax deduction such as medical expenses only helps if you have enough deductions to itemize. If you itemize, a deduction reduces your income. Therefore, you only save the amount of your tax bracket. For example, if you are in the 15 percent tax bracket, then $1.00
of deductions saves you $0.15 in income taxes. A tax credit of $1.00 saves you $1.00 in income taxes. See IRS Publication 17 for more on the difference between a tax credit and a deduction.

Taxpayers who owe taxes benefit most from tax credits since most tax credits can only be used to reduce the amount of income tax that you owe. Therefore, you will not benefit from a tax credit unless you owe taxes. There are two exceptions to this: the Child Tax Credit and the Earned Income Credit. Under certain circumstances, you will receive payments from the Child Tax Credit and the Earned Income Credit even if you do not need them to reduce the amount of federal income tax you owe. Tax credits are subtracted from the tax owed. If the credits are large enough, they could reduce the amount of tax due to less than you had deducted from your pay through federal withholding. When the amount you already paid through federal withholding is more than the total income tax you owe, you receive a refund.

### Child Tax Credit
The 2009 Child Tax Credit is $1,000 per child. If your tax form shows you owe federal income taxes, the amount you owe is reduced by the credit. However, you may be able to receive this credit in the form of a refund even if you do not owe any tax or did not use the full amount of the credit when figuring your tax. Use IRS Form 8812 to see if you are due a refund. If you are self-employed, the refund will be used to reduce any Social Security or Medicare taxes that you owe because you are self-employed. The overpayment created by the Child Tax Credit will be sent to you as a refund along with any refund due you for overpayment on withholding for the federal income tax. For more information, see IRS Publication 972, which includes the required worksheets to determine if you are entitled to the credit. As of the writing of this fact sheet, this credit is set to expire for tax years after 2009.

### Earned Income Tax Credit
The second tax credit that allows a refund is the Earned Income Tax Credit (EITC). There are new rules for determining eligibility for this credit. So even if you have not qualified before, it is worth checking again. In 2009, the income limit for single taxpayers with one qualifying child is $35,463 ($38,583 married filing jointly), $40,295 ($43,415 married filing jointly) with more than one qualifying child, or $13,440 ($16,560 married filing jointly) with no qualifying child.

For clarification on qualifying income and children see IRS Publication 596. For tax year 2009, the maximum credit is $5,028 with two or more qualifying children, $3,043 with one qualifying child, and $457 with no qualifying children. Investment income must be $3,100 or less for the year. You need to file IRS Form EIC with your tax return to claim this tax credit. If you expect to be eligible for this credit in 2009,
complete a W-5 Form at work to receive advance payments in each month’s paycheck. You must file a new W-5 Form with your employer each year to receive advance payments. For more information on EITC visit [http://www.eitc.irs.gov/central/main/](http://www.eitc.irs.gov/central/main/).

**Dependent Care Credit**

If you (and/or your spouse) work, are looking for work, or go to school and you pay someone to care for dependents (a child or elderly parent claimed as a dependent on your federal income return), you may be entitled to a Dependent Care Credit in addition to the Child Tax Credit. This is not a refundable credit; however, using this credit may reduce the amount of tax you owe and increase the refund created by the Earned Income Tax Credit and Child Tax Credit. To claim this credit, you, the taxpayer, must pay someone who you do not claim as a dependent, a nondependent, to provide the care. This caregiver must provide you with a taxpayer ID number or a Social Security number. If you use pre-tax dollars from your employer-sponsored Dependent Care Flexible Spending Account to pay these expenses, you cannot use the pre-tax dollars you paid to figure the credit. The amount of any Dependent Care Credit is figured as a percentage of the amount you paid for dependent care, and that percentage is based on your income. To claim this credit, you must file an IRS Form 244. For more information see IRS Publication 503.

**Flexible Spending Accounts**

Employer-sponsored Flexible Spending Accounts allow you to pay for dependent care and medical costs with pre-tax dollars. The amount you contribute to your account is deducted from your annual earnings before they are reported on your W-2 Form at the end of the year—your taxable income is reduced by the amount you contributed to the Flexible Spending Accounts. Your total annual contribution is divided by the number of paychecks you receive and is deducted evenly from each paycheck. You pay the bills out of your pocket and then submit the bills according to your employer’s instructions for reimbursement. Most employers allow you to submit bills up to the maximum annual contribution even if the full amount has not yet been deducted from your paycheck or deposited in the Flexible Spending Account. The maximum amount that can go into these accounts is $5,000 per employee, but your employer may set a lower limit. The drawback to Flexible Spending Accounts is that any money left in the account at the end of the year will go to your employer, not to you.

As with the Dependent Care Credit, the taxpayer must have a Social Security number or Tax ID number from the caregiver in order to submit bills for reimbursement. To determine whether the Flexible Spending Account or the Dependent Care Credit is best for you, consult a tax professional.
The Medical Flexible Spending (MFS) Account is structured similar to the Dependent Care Flexible Spending Account. Doctor visits and medications are likely to increase with the birth of a baby, so an MFS Account is an option to cover co-payments and other medical expenses not reimbursed by health insurance. Since most people cannot deduct these expenses at tax time, the MFS Account allows you to pay these expenses with pre-tax dollars.

This is one fact sheet in a series entitled *Children and Family Finances*. You may also want to review the *Planning for Baby* series.

This fact sheet was revised from Planning for Baby – Family Finances by Hayhoe, C., Jamison, S. Dillard, A. F., and Chase, M.

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