Taxpayers with Kids

Taxpayers with Kids: How to Make the Most Out of Your Annual Tax Return

Are you raising a child? You probably have some significant expenses. Food, clothing, health care, education expenses…they add up quickly. Wouldn’t it be great to have a little extra cash?

Help may be closer than you think! It turns out that the federal government makes several special credits available to parents and guardians of children. Two of these credits—the Additional Child Tax Credit and the Earned Income Tax Credit—are refundable. This means that qualifying taxpayers can receive a refund from the federal government, even if they paid no tax at all!

Dependency Exemption

The first step toward maximizing your federal tax benefits is to properly identify your dependents. IRS allows you to claim one dependency exemption for each “qualifying child.” You list each child’s name and social security number or ITIN on Form 1040, then add these dependency exemptions to your personal and spousal exemption (if applicable). You then use that number to figure your total allowance. For tax year 2016, these exemptions reduced taxable income by $4,050 each!

But what exactly does IRS mean by “qualifying child?” A qualifying child must satisfy a series of tests. First among these is the “relationship test.” A qualifying child must be your son or daughter, stepchild or foster child, sibling, half sibling, or stepsibling. Children, stepchildren, and foster children of these persons will also satisfy the “relationship test.”

A qualifying child must also satisfy the “age test”: she must be under 19 in general, under 24 if a full-time student, or any age if permanently disabled. A qualifying child must live with the taxpayer for more than half of the year (“residency test”)and must not have provided more than half of her own support (“support test”). Finally, a qualifying child must not have filed a joint return—unless she did so to claim a refund.

For children of divorced parents, separated parents, or parents living apart, special rules may apply. Generally speaking, the custodial parent should claim the dependency exemption. However, the noncustodial parent may be entitled to the exemption if the custodial parent releases her claim in writing with Form 8832.

Note: IRS Publication 501 is a great resource for taxpayers who seek to better understand exemption regulations; it's especially helpful for taxpayers with unique living situations. The publication is long, but it's well worth a read.

Child Tax Credit, Additional Child Tax Credit

The Child Tax Credit may substantially reduce your tax liability. For each qualifying child under age 17 at the end of the tax year, you may decrease your tax by up to $1000.

Here's an interesting situation: say you owe $1600 of tax per line 44, but you have two qualifying children. The Child Tax Credit zeroes out your liability with $400 left over. What happens to the extra $400?

That's where the Additional Child Tax Credit may come in. If you find yourself in a situation like this, complete Schedule 8812 to determine whether you qualify for the additional credit. The additional credit is equal to the lesser of the leftover Child Tax Credit or 15% of earned income above $3,000.

IRS Publication 972 explains all the ins-and-outs of the Child Tax Credit.

Child and Dependent Care Credit

Do you pay someone to care for your children while you work? Perhaps you pay for daycare or after-school services? Perhaps you employ a babysitter or a nanny? Taxpayers with children ages 12 and under may take a credit worth up to 35% of qualifying dependent care expenses.

Qualifying expenses are presently capped at $3,000 for one child or $6,000 for two or more children. Taxpayers with earned income of $15,000 or less may take advantage of the full 35% of qualifying expenses. The credit decreases as income increases; taxpayers who earn $43,000 or more can take a maximum of 20% of qualifying expenses.

To learn more about the Child and Dependent Care Credit, read IRS Publication 503 (Child and Dependent Care Expenses).

Earned Income Tax Credit (EITC)

The EITC exists to provide a small subsidy for low-income workers. For 2016, it was worth up to $6,269 in refundable cash based on family size and income level. Yet, surprisingly, 20% of qualifying taxpayers overlook the credit! Don't be one of these taxpayers! Find out whether you qualify. Learn more about the EITC here.

IRS provides a handy EITC Assistant tool. Use this tool first to gain a sense of whether you qualify. If you file a paper return, you will need to calculate the amount of your credit using the worksheet provided in the Instructions for Form 1040.

If you file your taxes using tax preparation software, the software will perform many of the actual EITC calculations for you. IRS Volunteer Income Tax Assistance (VITA) sites are also equipped to calculate the EITC.

Regardless of how you figure the credit, if you are claiming qualifying children, you need to attach Schedule EIC to your tax return.

Caution: The EITC is a wonderful resource, but it is also a potential red flag. Around 43% of all individual taxpayer audits are EITC audits. That doesn't mean you should avoid this credit: if you qualify, take advantage of it! Just be sure to fill out the forms carefully, and be prepared to demonstrate your child's dependency if asked.

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