New law tax break may make child care less expensive

The new American Rescue Plan Act (ARPA) provides eligible families with an enhanced child and dependent care credit for 2021. This is the credit available for expenses a taxpayer pays for the care of qualifying children under the age of 13 so that the taxpayer can be gainfully employed.

Note that a credit reduces your tax bill dollar for dollar.

Who qualifies?

For care to qualify for the credit, the expenses must be “employment-related.” In other words, they must enable you and your spouse to work. In addition, they must be for the care of your child, stepchild, foster child, brother, sister or step-sibling (or a descendant of any of these), who’s under 13, lives in your home for over half the year, and doesn’t provide over half of his or her own support for the year. The expenses can also be for the care of your spouse or dependent who’s handicapped and lives with you for over half the year.

The typical expenses that qualify for the credit are payments to a day care center, nanny or nursery school. Sleep-away camp doesn’t qualify. The cost of kindergarten or higher grades doesn’t qualify because it’s an education expense. However, the cost of before and after school programs may qualify.

To claim the credit, married couples must file a joint return. You must also provide the caregiver’s name, address and Social Security number (or tax ID number for a day care center or nursery school). You also must include on the return the Social Security number(s) of the children receiving the care.

The 2021 credit is refundable as long as either you or your spouse has a principal residence in the U.S. for more than half of the tax year.

What are the limits?

When calculating the credit, several limits apply. First, qualifying expenses are limited to the income you or your spouse earn from work, self-employment, or certain disability and retirement benefits — using the figure for whichever of you earns less. Under this limitation, if one of you has no earned income, you aren't entitled to any credit. However, in some cases, if one spouse has no actual earned income and that spouse is a full-time student or disabled, the spouse is considered to have monthly income of $250 (for one qualifying individual) or $500 (for two or more qualifying individuals).

For 2021, the first $8,000 of care expenses generally qualifies for the credit if you have one qualifying individual, or $16,000 if you have two or more. (These amounts have increased significantly from $3,000 and $6,000, respectively.) However, if your employer has a dependent care assistance program under which you receive benefits excluded from gross income, the qualifying expense limits ($8,000 or $16,000) are reduced by the excludable amounts you receive.

How much is the credit worth?

If your AGI is $125,000 or less, the maximum credit amount is $4,000 for taxpayers with one qualifying individual and $8,000 for taxpayers with two or more qualifying individuals. The credit phases out under a complicated formula. For taxpayers with an AGI greater than $440,000, it's phased out completely.

These are the essential elements of the enhanced child and dependent care credit in 2021 under the new law. Contact us if you have questions.