Financial Strategies to Get You Through the Pandemic

Fact Sheet Number 6

Tax Breaks for Child Care Expenses: Child & Dependent Care Credit and the Dependent Care Flexible Spending Account

Families paying for child care can choose from two ways to reduce their income taxes.

- Claim the Child & Dependent Care Credit when you file your income taxes.
- Have money deducted from your paycheck for a Dependent Care Flexible Spending Account.

You cannot count the same expenses for the Credit and for the Flexible Spending Account.

Child & Dependent Care Credit

The Child & Dependent Care Credit (Español)lets you claim a credit on your taxes for care of a child under age 13 that allowed you to work. Expenses such as day care, after school care, and summer day camp may qualify. You must provide either a Social Security or an Individual Taxpayer Identification Number (ITIN) for the care provider in order to claim the credit, unless the provider is a tax-exempt organization. The Credit is claimed by filing out Form 2441 and attaching it to your 1040 tax form (Español). Use the interactive assistant on the IRS website to determine whether or not you are eligible.

If you pay child care expenses, your credit could be substantially larger in 2021.

- The maximum credit is $4000 for the care of one person, or $8000 for two or more, compared to $1050 and $2100 for 2020.
    - How is it calculated? For 2021, the credit is 50% of qualifying expenses of up to $8000 for care of one person and $16,000 for two or more. For 2020, it was 35% of up to $3000 of care expenses for one child and up to $6000 for two or more.
- The credit is fully refundable for 2021. In 2020, it was not refundable, meaning that It could reduce the tax you owed, but it would not increase the amount of your refund.
- The credit is reduced for taxpayers earning over $125,000. Taxpayers with incomes up to $400,000 will get gradually smaller credits. In previous years, the credit was reduced when your income exceeded just $15,000.

There are a lot of details associated with this credit. For more information, check out IRS Publication 503, Child and Dependent Care Expenses. This publication is updated each year. As of April 1, 2021, it had not been updated with the 2021 changes.

Flexible Spending Accounts

Flexible Spending Accounts let employees reduce their taxes by having money for certain expenses deducted from their paychecks without paying tax on it. The money is deposited into an account used specifically to pay for either child care, medical expenses, or commuter expenses that year. Employers choose whether to offer Flexible Spending Accounts, and some employers only offer one or two types.

The employer must sign up each year during open enrollment. You agree to have a certain amount deducted from each paycheck for the entire year. That part of your income avoids all taxes: federal and state income taxes, Social Security and Medicare taxes. The savings can be significant, especially for higher income earners.

You must use the money to pay eligible expenses during the year. Money left at the end of the year may be lost.

Changes include:

- For 2021:
  - Higher limits for contributions to Dependent Care Flexible Spending Accounts. The limit increased from limit increased from $5000 to $10,500 for employees whose tax filing status is single or married jointly, and from $2500 to $5250 for married filing separately.
    - However, each employer decides whether to allow the increased contributions.
  - May be paid monthly beginning summer 2021
- For 2020 and 2021: With limited exceptions, you lose any money left in a Flexible Spending Account at the end of the year. But for 2020 and 2021, you can roll over any unused money to use the next year.

Choose Flexible Spending Account <u>or</u> Child & Dependent Care Credit

If you use a flexible spending account to pay for care expenses, you cannot use the same expenses to claim the Child & Dependent Care Credit. You should compare the tax benefits to see which one is better for you.