

## Basics of the Dependent Care Credit

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Many taxpayers are eligible for the Dependent Care Tax Credit. This credit has been in an evolutionary state for more than two decades, being tweaked over the years by various pieces of legislation. So, we thought it might be a good time to review some of the basics of this beneficial credit.

Depending on the taxpayer's income, the credit ranges from 20% to 35% of the dependent care expenses (limitations apply) paid and incurred while the taxpayer and spouse, if married, are gainfully employed. The care must be for a qualifying individual.

As the taxpayer's income increases, the nonrefundable credit is gradually reduced from 35% to 20% of the lesser of the qualifying expenses or earned income of the taxpayer and spouse, if married. There is also an overall limitation of \$3,000 for one qualifying person or \$6,000 for two or more qualifying persons. A qualifying individual is either a qualifying child under age 13, or a dependent or spouse who is physically or mentally incapable of self-care and has the same principal place of abode as the taxpayer for at least half of the year. The credit is allowed to married taxpayers only if they file a joint return.

To claim the credit, child and dependent care expenses provided for the well-being and protection of a qualifying individual must be incurred to enable the taxpayer (and spouse, if married) to work. This means if the expenses were for household services, part of the services must have been for the care of a qualifying individual. Thus, expenses for ordinary household services (such as a housekeeper, maid, or cook) that are necessary to run the home qualify for the credit if part of the expenses relate to the care of a qualifying individual.

**Example:** Danielle, a single parent, pays Bea (who is over age 18 and not a relative) to care for her child, age 10, after school in her home while she is at work. The entire amount paid enables her to work, and thus is eligible for the credit, even though Bea performs household services in addition to child care. As Bea's employer, Danielle is liable for the employer's portion of FICA if she pays wages of \$1,500 or more.



Expenses for care outside the taxpayer's home qualify for the credit if incurred to allow the taxpayer(s) to work, and the main reasons for the expenses are the well-being and protection of the qualifying person.

**Example:** Jack places his five-year-old son in a daycare center each workday. The center provides breakfast and lunch, as well as various educational activities. While amounts paid for food and education generally are not considered work-related expenses, services that are incidental to and cannot be separated from the cost of caring for a qualifying person are not excluded from the credit computation. Costs for care outside the home are eligible if the qualifying individual regularly spends eight hours or more per day in the taxpayer's household. Jack's son meets this requirement.

The cost of a day camp or similar programs may be for the care of a qualifying individual and an employment-related expense, even if the day camp specializes in a particular activity.

**Example:** For two weeks during the summer, Jack puts his son into a day camp sponsored by his church. If all

other requirements are met (as discussed in the previous example), the cost of the day camp should qualify as a dependent care expense. On the other hand, if Jack's son stays overnight at the camp during the two-week period, the cost does not qualify as a dependent care expense.

One final point: a tax credit offsets your tax liability on a dollar-for-dollar basis. So, we want to ensure that you benefit from this and any other available credit. Please call us with any questions you might have on the Dependent Care Tax Credit or any other individual or business tax issue.



April 2007

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## Hybrid Vehicle Credit Phase-out Continues for Toyota Brands

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Sales of Toyota (including Lexus) hybrid vehicles were brisk throughout 2006, totaling 212,073 vehicles for the year. As a manufacturer's sales of qualifying vehicles passes a 60,000-unit threshold, the Alternative Vehicle Credit begins a phase-out process. The credit for Toyota brands was reduced to 50% of the original amount on October 1, 2006, and subsequently to 25% of the original amount on April 1, 2007. The credit is completely phased-out for vehicles purchased after September 30, 2007.

The phase-out's effect can be seen by reviewing the credit available on the popular Toyota Prius. The original credit of \$3,150 was reduced to \$1,575 on October 1, 2006 and subsequently to \$787.50 on April 1, 2007. No credit will be available on the Prius after September 30, 2007 when the credit is completely phased-out.

## **Merck Settles with IRS for \$2.3 Billion**

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Drug maker Merck will pay the IRS \$2.3 billion to resolve several tax disputes. The settlement covers taxes, interest, and penalties related to tax years 1993 through 2001. The primary dispute related to a tax-saving partnership with a British bank based in Bermuda. The resolution is one of the largest achieved in recent years by the IRS and a taxpayer through the examination process.

Although large, the recent settlement with Merck was not the largest with a major drug manufacturer. Last September, Glaxo SmithKline Holdings (Americas) Inc. & Subsidiaries agreed to pay the IRS \$3.4 billion in what was the largest tax settlement ever with a major drug manufacturer.

## Potential Double Benefit from a Tax Deduction

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For most taxpayers, the amount of federal income tax they pay each year often depends upon where they fall in the federal income tax brackets and on the breakdown of their taxable income between ordinary (e.g., wages) and capital gains from the sale of assets (e.g., common stock). Taxpayers eligible for the lower federal income tax brackets (those under 25%) on their ordinary income can generally expect to be taxed at a rate of only 5% (exceptions apply) on their long-term capital gains. Taxpayers finding themselves in the 25% or higher federal income tax brackets can generally expect to be taxed at a 15% rate (again, exceptions apply) on at least a portion of their long-term capital gains.



So, if it is inevitable that as our federal taxable income increases the rate of tax we pay on at least a portion of that income also increases, the converse should and does apply. That is, as our federal taxable income decreases the rate of tax we pay on at least a portion of that income will decrease. In addition, if a taxpayer has a long-term capital gain that, after considering ordinary income, is partially taxed at the 15% rate, any additional deduction that decreases ordinary income will simultaneously diminish the taxation of a comparable amount of long-term capital gain from the 15% bracket to the 5% bracket. This has the effect of producing a *double benefit* for that deduction as shown in the example below.

**Example:** Jeff and Jani, filing jointly for 2007, have net ordinary income of \$50,000 and a long-term capital gain from the sale of stock of \$40,000. For 2007, the joint rates applicable to ordinary income change from 15% to 25% at \$63,700. Accordingly, \$13,700 (\$63,700 - \$50,000) of their long-term capital gain will be taxed at 5% and the balance of \$26,300 (\$40,000 - \$13,700) is taxable at 15%. In this example, all income, both capital and ordinary, is taxed at a rate of 15% or less.

If Jeff and Jani contribute \$8,000 to their *deductible* IRAs (\$4,000 each for 2007), they will receive a 25% tax rate savings, even though their highest tax bracket is 15%. The \$8,000 IRA deduction reduces ordinary income at the 15% ordinary federal tax rate, but also has the effect of shifting \$8,000 of capital gain taxation from the 15% to the 5% bracket, for another 10% savings. This produces a total tax benefit of 25% on the \$8,000 reduction.

A similar impact would occur for any expenditure or deduction that reduced ordinary income (e.g., Section 179 bonus depreciation, additional interest expense, etc.).

## Save Tax on Savings Bond Interest

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U.S. Savings Bonds are unlikely to ever be the stars of the investment world. However, they come with a special tax benefit that has helped make them attractive to a generation of savers. You can purchase the bonds and then basically ignore them for years if you like because unless you elect otherwise, the interest they earn isn't taxable until the bonds mature or are redeemed for cash. Because of this feature, and the fact that they're considered by many to be one of the safest investments around, millions of taxpayers have savings bonds tucked away somewhere.

However, at the bondholder's death, one of the downsides to these bonds comes into play. Stock or mutual fund investments are "stepped up" (or down) to their value at the decedent's date of death so that, if the beneficiary immediately sells the inherited asset, there is no gain or loss. However, U.S. Savings Bonds are inherited by the beneficiary at the decedent's original cost basis unless the decedent previously elected to include the bonds' interest as income in the years it accrued, which is unlikely. Thus, if you cash in a significant amount of inherited U.S. Savings Bonds, there's likely to be substantial interest income that's going to be taxable to you at your marginal tax rate. That's obviously not good news.



A recent Tax Court decision explains a potential solution to this problem. The decedent's executor can elect to include the accrued interest to the date of death in the decedent's final return. In situations where the decedent had little or no other taxable income in the year of death, this can substantially lower the tax on the interest income. This option is even available in situations where, after including the accrued interest from the bonds, the decedent still owes no income tax on the final return, but has to file the return to report the interest income (the return just won't show a balance due).

Please call us if you have any questions about how this planning opportunity might work in your situation or about any other personal or business tax issues.

**Tax Calendar**[Back](#)

**April 17** - Besides being the last day to file (or extend) your 2006 personal return and pay any tax that is due, 2007 first quarter estimated tax payments for individuals, trusts, and calendar-year corporations are due today. So are 2006 returns for trusts and calendar-year estates, partnerships, and LLCs, plus any final contribution you plan to make to an IRA or Education Savings Account for 2006. SEP and Keogh contributions are also due today if your return is not being extended.

-If you need to file a 2006 gift tax return, it also must be filed or extended by this date.

-If you paid cash wages of \$1,500 or more in 2006 to a household employee, you must file Schedule H by this date, unless it is included with an extended Form 1040. You may also have to report any federal unemployment tax paid and any income tax you withheld for your household employees.

**April 30** - If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through March 31 exceeds \$500.

-The first quarter Form 941 (Employer's Quarterly Federal Tax Return) is also due today (except that you have until May 10 to file if you deposited all taxes for the quarter when they were due).

**June 15** - Second quarter estimated tax payments for individuals, trusts, and calendar-year corporations are due today.

