Tips Regarding Your Flexible Spending Account for 2004 Child and Dependent Care Expenses

Your employer offers you the opportunity to save as much as $2,100 in federal taxes in 2004 by participating in a flexible benefits plan for child and dependent care expenses. The amount of money you save on your taxes will depend on your income level, the amount of your child and dependent care expenses, and whether you are eligible for and claim the federal Earned Income Tax Credit ("EITC"). This tip sheet helps you decide whether to participate in a flexible benefits plan for child and dependent care expenses, which we will refer to as a Dependent Care Assistance Program ("DCAP"), and which your employer may refer to as a Dependent Care Spending Account or a Dependent Care Reimbursement Plan.

How a DCAP works.

The federal government allows you to set aside up to $5,000 of your annual salary in a DCAP (your employer may impose a lower limit). Your salary is reduced each pay period by the amount you designate, and this amount is returned to you in the form of a tax-free reimbursement for child and dependent care expenses. You do not have to pay federal income taxes or Social Security and Medicare taxes on the amount you set aside. The savings to you is the amount of money you would have paid in these taxes if your salary had not been reduced.

How much to set aside.

You must decide toward the end of 2003 (your employer will tell you the exact date) how much money you would like to set aside for child and dependent care expenses during 2004. You should set aside only as much money as you are confident you will spend on qualifying child and dependent care expenses during 2004. In general, if you do not spend the full amount that you designate for salary reduction for the 2004 plan year during that year, you lose the right to receive the "leftover" money. This is sometimes referred to as the "use it or lose it" rule and means that it is important to be careful when designating the amount of salary reduction that you want.

How you qualify.

Your employer's written DCAP plan provides the eligibility criteria for your participation. In general, to participate in a DCAP, you must have work-related child or dependent care expenses for a qualifying child or dependent.

Who is a qualifying child or dependent?

A qualifying child is a child under age 13 at the time care was provided who lives with you in 2004 and whom you can claim as a dependent on your 2004 tax return. A qualifying dependent is 1) a disabled individual (including a child older than 13 or a parent) who lives with you in 2004, is physically or mentally incapable of self-care, and whom you can claim as a dependent on your 2004 tax return, or 2) a disabled spouse who lives with you in 2004 and is physically or mentally incapable of self-care.

What type of care qualifies?

Most types of child and dependent care qualify as long as you pay for the care and the care is necessary for you to work or look for work in paid employment. If you are married, both you and your spouse must need the care to work or look for work, or one spouse must be a full-time student or incapable of self-care. In addition, if the care is provided in a place that provides care for more than six persons, the provider must meet all applicable state and local regulations. In the case of a dependent, the care must be for an individual who regularly spends at least eight hours a day in your home, so care in a residential care facility (such as a nursing home) for spouses or other individuals who are incapable of self-care is not eligible.

There may be other restrictions or limitations than the ones mentioned here. Consult your human resources department for further information.

What information is required?

Although DCAP benefits are provided through your employer, you must report the receipt of such benefits on your federal tax return. If you are married you must file a joint return, although special rules apply if you live apart from your spouse. In reporting your DCAP benefits, you must provide a Social Security number for any qualifying child or dependent. To get a Social Security number, contact your local Social Security Administration office or call the Social Security Administration's toll-free number, 1-800-772-1213.

You must also report basic information about your provider, including the provider's name, address, and, if the provider is not a tax-exempt organization, an identification number (the provider's Social Security number or employer identification number). If you try to get your provider's identification number but are not successful, you can explain on your tax return that you asked for the information but the provider did not comply with your request.

How a DCAP differs from the federal tax credit for child and dependent care expenses.

In addition to a DCAP, another tax benefit for child and dependent care expenses exists at the federal level, the Dependent Care Tax Credit ("DCTC"). The DCTC is claimed after the end of the tax year, when you file your tax return. The eligibility criteria for participating in a DCAP and claiming the DCTC are the same, for the most part. However, while you can claim up to $5,000 in expenses through a DCAP, the expense limits are different for the DCTC: you can claim up to $3,000 in expenses for the DCTC for one child or dependent, and up to $6,000 in expenses for two or more children or dependents.

How to decide whether to participate in a DCAP.

In most cases, you have to choose between participating in a DCAP and claiming the DCTC. This is because if you participate in a DCAP, you must subtract the amount of any expenses that are reimbursed through the DCAP from the expenses you can use to calculate the DCTC. For example, if you have $5,000 in qualifying expenses and set aside $5,000 in a DCAP, you cannot claim the DCTC.

If you have child or dependent care expenses in excess of what you are allowed to claim through a DCAP (either because of the $5,000 limit imposed by law or a limit set by your employer), you should claim the DCTC for those expenses (assuming you are still within the DCTC expense limits). For example, if you have $7,000 in qualifying expenses for two or more children or dependents and you set aside $5,000 in expenses in a DCAP, you should claim the DCTC for $1,000 in expenses ($6,000 expense limit for the DCTC – $5,000 set aside in DCAP = $1,000).

For the child and dependent care expenses that you can claim through a DCAP, however, you must decide whether to participate in a DCAP or claim the DCTC. For these expenses, with two exceptions, most people will receive more federal tax savings from participating in a DCAP than from claiming the DCTC. (This occurs because the amount saved in federal income taxes and Social Security and Medicare taxes by participating in a DCAP is greater than the amount saved in federal income taxes by claiming the DCTC. For some families who receive the EITC, this greater federal tax savings from participating in a DCAP occurs because participation in a DCAP reduces the amount of income used to calculate the EITC, which can result in a larger EITC.) The two exceptions are:

Most people will receive more federal tax savings from participating in a DCAP than from claiming the DCTC.

- If you claim the EITC[1] on your tax return for 2004 and your participation in a DCAP would reduce your adjusted gross income[2] for 2004 below $14,050 (if you are single) or below $15,050 (together with your spouse's adjusted gross income, if you are married), you will usually receive more 2004 tax savings from claiming the DCTC than from participating in a DCAP.
- If your adjusted gross income for 2004 (together with your spouse's adjusted gross income) is between $30,000 and $40,000, you may receive more 2004 federal tax savings from claiming the DCTC than from participating in a DCAP. If your 2004 adjusted gross income is in this range, the accompanying tables will help you figure out whether participating in a DCAP or claiming the DCTC is more advantageous for you.

Note: The DCTC is different from the federal Child Tax Credit, which can be worth as much as $1,000 per child. The amount of your federal Child Tax Credit is not affected either by your child care expenses or by whether you decide to participate in a DCAP.

[1] In general, you are eligible for the 2004 EITC if
- you have one qualifying child and your 2004 earned income and adjusted gross income is $30,348 or less (if you are single), or $31,348 or less (together with your spouse's earned income and adjusted gross income, if you are married); or
- you have two or more qualifying children and your 2004 earned income and adjusted gross income is $34,487 or less (if you are single), or $35,487 or less (together with your spouse's earned income and adjusted gross income, if you are married).

[2] In general, adjusted gross income is gross income, minus certain allowable deductions. It includes wages, salaries and tips and net income from self-employment, as well as unemployment compensation, alimony and taxable interest received, but not child support payments received. Certain allowable deductions include student loan interest and alimony paid.

DCAP vs. DCTC: Which Is Better for Families with Incomes Between $30,000 and $40,000?

For the child and dependent care expenses that can be claimed through a DCAP, taxpayers must decide whether to participate in a DCAP or claim the DCTC. The following tables indicate whether tax-payers with adjusted gross incomes between $30,000 and $40,000 in 2004 would receive more federal tax savings from participating in a Dependent Care Assistance Program (DCAP) or claiming the Dependent Care Tax Credit (DCTC) for those expenses, depending on income level, level of child or dependent care expenses, and type of family.

Single Parent with One Child

Adjusted Gross Income	Child or Dependent Care Expenses				
	$1,000	$2,000	$3,000	$4,000	$5,000+
$30,000	DCAP	DCAP	DCAP	DCAP	DCAP
$31,000	DCAP	DCAP	DCAP	DCAP	DCAP
$32,000	DCTC	DCTC	DCAP	DCAP	DCAP
$33,000	DCTC	DCTC	DCTC	DCAP	DCAP
$34,000	DCTC	DCTC	DCTC	DCAP	DCAP
$35,000	DCTC	DCTC	DCTC	DCAP	DCAP
$36,000	DCTC	DCTC	DCTC	DCAP	DCAP
$37,000	DCTC	DCTC	DCTC	DCAP	DCAP
$38,000	DCTC	DCTC	DCTC	DCAP	DCAP
$39,000	DCTC	DCTC	DCTC	DCAP	DCAP
$40,000	DCAP	DCAP	DCAP	DCAP	DCAP

Single Parent with Two Children

Adjusted Gross Income	Child or Dependent Care Expenses				
	$1,000	$2,000	$3,000	$4,000	$5,000+
$30,000	DCAP	DCAP	DCAP	DCAP	DCAP
$31,000	DCAP	DCAP	DCAP	DCAP	DCAP
$32,000	DCAP	DCAP	DCAP	DCAP	DCAP
$33,000	DCAP	DCAP	DCAP	DCAP	DCAP
$34,000	DCAP	DCAP	DCAP	DCAP	DCAP
$35,000	DCAP	DCAP	DCAP	DCAP	DCAP
$36,000	DCTC	DCAP	DCAP	DCAP	DCAP
$37,000	DCTC	DCTC	DCAP	DCAP	DCAP
$38,000	DCTC	DCTC	DCTC	DCAP	DCAP
$39,000	DCTC	DCTC	DCTC	DCTC	DCAP
$40,000	DCAP	DCAP	DCAP	DCAP	DCAP

DCAP vs. DCTC: Which Is Better for Families with Incomes Between $30,000 and $40,000?

For the child and dependent care expenses that can be claimed through a DCAP, taxpayers must decide whether to participate in a DCAP or claim the DCTC. The following tables indicate whether taxpayers with adjusted gross incomes between $30,000 and $40,000 in 2004 would receive more federal tax savings from participating in a Dependent Care Assistance Program (DCAP) or claiming the Dependent Care Tax Credit (DCTC) for those expenses, depending on income level, level of child or dependent care expenses, and type of family.

Married Couple with One Child

Adjusted Gross Income	Child or Dependent Care Expenses				
	$1,000	$2,000	$3,000	$4,000	$5,000+
$30,000	DCAP	DCAP	DCAP	DCAP	DCAP
$31,000	DCAP	DCAP	DCAP	DCAP	DCAP
$32,000	DCTC	DCAP	DCAP	DCAP	DCAP
$33,000	DCTC	DCTC	DCTC	DCAP	DCAP
$34,000	DCTC	DCTC	DCTC	DCAP	DCAP
$35,000	DCTC	DCTC	DCTC	DCAP	DCAP
$36,000	DCTC	DCTC	DCTC	DCAP	DCAP
$37,000	DCTC	DCTC	DCTC	DCAP	DCAP
$38,000	DCTC	DCTC	DCTC	DCAP	DCAP
$39,000	DCTC	DCTC	DCTC	DCAP	DCAP
$40,000	DCAP	DCAP	DCAP	DCAP	DCAP

Married Couple with Two Children

Adjusted Gross Income	Child or Dependent Care Expenses				
	$1,000	$2,000	$3,000	$4,000	$5,000+
$30,000	DCAP	DCAP	DCAP	DCAP	DCAP
$31,000	DCAP	DCAP	DCAP	DCAP	DCAP
$32,000	DCAP	DCAP	DCAP	DCAP	DCAP
$33,000	DCAP	DCAP	DCAP	DCAP	DCAP
$34,000	DCAP	DCAP	DCAP	DCAP	DCAP
$35,000	DCAP	DCAP	DCAP	DCAP	DCAP
$36,000	DCAP	DCAP	DCAP	DCAP	DCAP
$37,000	DCTC	DCAP	DCAP	DCAP	DCAP
$38,000	DCTC	DCTC	DCAP	DCAP	DCAP
$39,000	DCTC	DCTC	DCTC	DCAP	DCAP
$40,000	DCAP	DCAP	DCAP	DCAP	DCAP

Effect on state taxes.

The preceding analysis evaluates the effect on your federal income taxes and Social Security and Medicare taxes of participating in a DCAP. You may also receive some savings on your state taxes from participating in a DCAP. However, participating in a DCAP may adversely affect your ability to claim a state child and dependent care tax provision, and in some cases it would be better for you to claim the federal DCTC and your state child and dependent care tax provision than to participate in a DCAP. Especially if you live in California, Minnesota, Nebraska, New York, or Oregon, you should be sure you weigh the effect on your state taxes before deciding to participate in a DCAP; you may be better off claiming the federal DCTC and your state child and dependent care tax provision than participating in a DCAP.

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This tipsheet is also available at www.nwlc.org or www.abcdependentcare.com

[3] The following states have child and dependent care tax provisions: Arkansas, California, Colorado, Delaware, District of Columbia, Hawaii, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Montana, Nebraska, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Virginia, and Vermont.