TAX BREAKS FOR GRANDPARENTS RAISING THEIR GRANDCHILDREN

More and more individuals who thought their child-rearing days were over are now raising their grandchildren. Grandparents in that challenging situation and those who think they might be in that situation some day should be aware a variety of tax breaks may be available to ease the financial burden of becoming primary caregivers for grandchildren. These include head of household filing status, exemption for the child, earned income credit (EIC), child tax credit (CTC), credit for child and dependent care expenses, credits or deductions for qualified education expense, deductions for medical and dental expenses, the adoption credit and state tax breaks.

All dollar amounts in this *Hot Topic* are those applicable to 2017.

- Head of household filing status.

  An individual who is considered unmarried and has a qualifying child may be eligible to use head of household as his or her filing status. This filing status generally is more favorable than the single filing status.

  An unmarried taxpayer may qualify as a head of household by maintaining as his or her home a household which is the principal place of abode for more than half the year of: (1) a qualifying child of the taxpayer; or (2) an individual for whom the taxpayer may claim a dependency deduction. However, the taxpayer won't qualify as a head of household if the qualifying child is married at the close of the taxpayer's tax year and is not a dependent of the taxpayer because he or she filed a joint return, or because he or she isn't a U.S. citizen or resident, or both.

  A "qualifying child" is an individual who: (1) bears a specified relationship to the taxpayer including being a grandchild of the taxpayer; (2) has the same principal place of abode as the taxpayer for more than one-half of that tax year; (3) hasn't attained a specified age (see below); and (4) hasn't provided over one-half of his or her own support for the calendar year in which the taxpayer's tax year begins.

  An individual meets the age requirement in (3), above, if he or she:

  - hasn't attained the age of 19 as of the close of the calendar year in which the tax year of the taxpayer begins;
  - is a student who hasn't attained the age of 24 as of the close of that calendar year; or
  - is permanently and totally disabled at any time during the calendar year.

  Subject to the exception in the next sentence, if two or more taxpayers can claim an individual as a qualifying child for a tax year beginning in the same calendar year, then the individual is treated as the qualifying child of the taxpayer who is: (1) a parent of the individual, or if item (1) doesn't apply; (2) the taxpayer with the highest adjusted gross income (AGI) for that tax year. If an individual's parents can claim the individual as a qualifying child but no parent does, then another taxpayer can claim the individual as a qualifying child, but only if that taxpayer's AGI is higher than the AGI of either parent of the individual.

Observation. Thus, if, for example, both the child and one or both of the child's parents live with the grandparent for more than one-half of the tax year, the child is a qualifying child of the grandparent only if neither parent claims the child as a dependent and the grandparent has a higher AGI than does either of the child's parents.

- Exemption for the child.

A grandparent who has a child living with him or her may be able to claim the child as a dependent and, if so, qualify for other tax breaks, as noted below.

A taxpayer is entitled to a deduction equal to the exemption amount for each person who qualifies as his or her "dependent." A person generally qualifies as the taxpayer's dependent if the person is the taxpayer's qualifying child (see above) or qualifying relative. The exemption amount is $4,050.

- Earned income credit.

A grandparent who is working and has a qualifying child living with him or her may be able to take the EIC.

An eligible individual (see below) is allowed an EIC equal to the credit percentage of earned income (up to an "earned income amount") for the tax year. The EIC for a tax year (determined under IRS tables) can't be more than the excess (if any) of (1) the credit percentage of the earned income amount, over (2) the phase out percentage of AGI (or earned income, if greater) over a phase out amount.

An individual who has a "qualifying child" for the tax year is an eligible individual.

Note. Having a qualifying child isn't the exclusive say to be an eligible individual, but those who qualify as eligible individuals in another way aren't the subject of this article.

A "qualifying child" for EIC purposes means a qualifying child of the taxpayer, as defined for the dependency exemption, but without the requirement the child didn't provide more than half of his own support.

To qualify for an EIC on account of a grandchild or grandchildren, a taxpayer's adjusted gross income (AGI) must be less than certain specific amounts which depend on the number of qualifying children the grandparent has. For example, for 2016, for a grandparent with three or more qualifying children, the AGI limit is: $48,340 ($53,930 for married filing jointly). There's no EIC if the taxpayer files as a married filing separately, isn't a U.S. citizen or resident alien all year, files Form 2555 or Form 2555-EZ (relating to foreign earned income), doesn't have earned income, or has more than $3,450 of investment income.

- Child tax credit.

A grandparent who is raising a grandchild may be able to take the CTC and, under specific circumstances, the CTC may be refundable.

Individuals may claim a maximum $1,000 CTC for each qualifying child the taxpayer can claim as a dependent. The child must be less than 17 and a U.S. citizen or resident alien.

The amount of the allowable credit is reduced (not below zero) by $50 for each $1,000 (or fraction thereof) of modified AGI (AGI increased by excluded foreign, possession, and Puerto Rico income) above: $110,000 for joint filers; $75,000 for unmarried individuals; and $55,000 for married filing separately.

The CTC is refundable, but only to the extent of the greater of: (1) 15% of taxable earned income above $3,000 for 2017; or (2) for a taxpayer with three or more qualifying children, the excess of his or her social security taxes for the tax year over his EIC for the year. The IRS calls the amount of the CTC which is refundable (on Form 1040, Schedule 8812, Child Tax Credit) the "additional child tax credit."

- Credit for child and dependent care expenses.

  This credit may be available if a grandparent pays someone to care for a qualifying individual, who has the same principal place of abode as the grandparent for more than half the tax year, where the amounts are paid for period in which the grandparent works or looks for work. A qualifying individual is: (1) a dependent under age 13, or (2) the grandparent's spouse, or a dependent, who is physically or mentally not able to care for himself or herself.

  The credit is 35% of employment-related expenses for taxpayers with AGI of $15,000 or less. The percentage decreases by 1% for each $2,000 (or fraction thereof) of AGI more than $15,000, but not below 20%. The maximum amount of employment-related expenses which may be used to compute the credit is $3,000 for one qualifying individual, or $6,000 for two or more qualifying individuals. These maximums must be reduced, dollar-for-dollar, by the total amount excludable from gross income.

- Education expenses.

  There is a number of tax breaks which may be available to a grandparent who pays his or her grandchild's education costs. Except where otherwise indicated below, the tax break doesn't require the grandchild to be a qualifying child of the grandparent.

  - *Education credits*. An individual taxpayer may claim an income tax credit for the American Opportunity Tax Credit (AOTC) and the Lifetime Learning Credit for higher education expenses at accredited post-secondary educational institutions paid for themselves, their spouses, and their dependents. The AOTC is available for qualified expenses of the first four years of undergraduate education; the Lifetime Learning Credit is available for qualified expenses of any post-high school education at "eligible educational institutions." Both credits can't be claimed in the same tax year for expenses of any one student, and they phase out for higher-income taxpayers.

    The AOTC is equal to 100% of up to $2,000 of qualified higher education tuition and related expenses plus 25% of the next $2,000 of expenses paid for education furnished to an eligible student in an academic period. So, the maximum AOTC is $2,500 a year for each eligible student. For 2017, the availability of the AOTC phases out ratably for taxpayers with modified AGI (i.e., AGI increased by foreign, possessions, and Puerto Rico income exclusions) of $80,000 to $90,000 ($160,000 to $180,000 for joint filers).

Taxpayers may elect a Lifetime Learning Credit equal to 20% of up to $10,000 of qualified tuition and related expenses paid during the tax year. The maximum credit is $2,000. Unlike the AOTC, which is available for the qualifying expenses of each qualifying student, the Lifetime Learning Credit is a per-taxpayer credit. For 2017, this credit is phased out ratably for taxpayers with modified AGI from $56,000 to $66,000 ($112,000 to $132,000 for married filing jointly).

- *Coverdell Education Savings Accounts (CESAs)*. Taxpayers can contribute up to $2,000 per year to CESAs for beneficiaries under age 18 (unless the beneficiary has special needs, in which case there is no limit). The account is exempt from income tax, and distributions of earnings from CESAs are tax-free if used for qualified education expenses. If the contributor is an individual, the $2,000 limit phases out ratably between $95,000 and $110,000 ($190,000 and $220,000 for joint filers) of modified AGI.

- *Qualified Tuition Programs (QTPs) - 529 Plans*. A person can make nondeductible cash contributions to a QTP/529 plan on behalf of a designated beneficiary. The earnings on the contributions build up tax-free, and distributions from a QTP are excludable to the extent used to pay for qualified higher education expenses.

- *Higher education exclusion for savings bond income*. Qualified U.S. savings bond interest income is excluded to the extent redemption proceeds don't exceed qualified higher education expenses. For 2017, the exclusion phases out for a taxpayer whose modified AGI for the year exceeds $78,150 ($117,250 on a joint return). Qualified higher education expenses are tuition and fees required for the enrollment or attendance of taxpayer, taxpayer's spouse or any dependent for whom taxpayer is allowed a dependency exemption, at an eligible educational institution, e.g., most colleges, junior colleges, nursing schools and vocational schools.

- *Above-the-line deduction for higher-education expenses (before 2017)*. For tax years beginning before 2017, eligible individuals could deduct higher education expenses - i.e., “qualified tuition and related expenses” of the taxpayer, his or her spouse, or dependents - as an adjustment to gross income to arrive at adjusted gross income. The higher education deduction couldn't exceed: $4,000 for taxpayers whose modified AGI for the tax year didn't exceed $65,000 ($130,000 for a joint return); $2,000 for taxpayers whose modified AGI exceeded $65,000 ($130,000 for a joint return), but didn't exceed $80,000 ($160,000 for a joint return); and zero for other taxpayers.

  The higher education expense deduction wasn't allowed for a tax year with respect to an individual's expenses if the taxpayer or any other person elected to claim an education credit with respect to that individual for that year.

- *Deduction for interest on qualified education loans*. Qualifying individuals may claim an above-the-line deduction for up to $2,500 of interest paid on a qualified higher education loan, i.e., any debt incurred by the taxpayer solely to pay qualified higher education expenses that are: (1) incurred on behalf of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the debt was incurred; (2) paid or incurred within a reasonable period of time before or after the debt is incurred; and (3) attributable to education furnished during a period when the recipient was an eligible student (as defined for education credit purposes, i.e., at least a half-time student).

For 2017, the deduction phases out ratably for taxpayers with modified AGI between $65,000 and $80,000 ($135,000 and $165,000 for joint returns). Modified AGI is AGI figured without regard to the deduction for qualified education loan interest, the pre-2017 deduction for qualified higher education expenses, the U.S. production activities deduction, and without regard to the exclusions for foreign, possession, and Puerto Rico income.

- Medical and dental expenses.

  An individual who itemizes can deduct the amount by which certain unreimbursed medical and dental expenses paid during the year for himself or herself, his or her spouse, and his or her dependents exceed 10% of his adjusted gross income.

  Note. The American Health Care Act, which was approved by the House of Representatives on May 4, 2017, would decrease the 10% to 5.8%.

- Adoption expenses.

  If a grandparent legally adopts his or her grandchild, he or she is eligible for a credit of up to $13,570 for 2017. In addition to adoption fees, qualified expenses include court costs, attorney fees, and travel expenses. A legally adopted grandchild is treated the same way as a child “by blood.” For an adoption of a child with special needs, the taxpayer is treated as having paid (in the tax year the adoption becomes final) the maximum credit amount regardless of actual expenses.

- Employer benefits.

  Grandparents who are still employed when they take on primary caretaker responsibilities for a grandchild should consult their company's human resources representative to see if they are eligible for grandchild-related benefits under various employer plans, such as health reimbursement arrangements, health flexible spending arrangements (health FSAs), employer provided health plans, and dependent care assistance programs.

- State tax breaks.

  Similar to many of the rules discussed above, states provide tax breaks to grandparents with respect to their grandchildren, particularly where the grandchild is a qualifying child or meets similar state-provided rules.

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