

LAW SUMMARY

California Child and Dependent Care Expenses (CDC) Credit

1. INTRODUCTION

This Law Summary explains the requirements that must be met for a taxpayer to establish qualification for the Child and Dependent Care Expenses (CDC) Credit.

Revenue and Taxation (Rev. & Tax.) Code section 17052.6 sets forth the rules for who is entitled to the California CDC Credit by reference to Internal Revenue Code (IRC) section 21.

It is well settled that credits (and deductions) are a matter of legislative grace, and the taxpayer bears the burden of establishing entitlement to claimed credits. (See section 12, Burden of Proof, for further explanation and authorities.)

A taxpayer, who qualified for the federal CDC Credit and whose federal adjusted gross income (AGI) is not over \$100,000, can claim a *percentage* of the federal CDC Credit on his or her California tax return.

A taxpayer who did not file a federal return or claim the federal credit may still claim the credit for California. The taxpayer must complete FTB Form 3506 and attach it to his or her California income tax return.

California allows this refundable credit only for care provided in California. (Rev. & Tax. Code section 17052.6(e)(1).)

2. THE CALCULATION/PERCENTAGES

The California credit is a percentage of the federal credit, based on the taxpayer's federal AGI as follows:

<u>Federal AGI</u>	<u>California Credit</u>
\$40,000 or less	50% of federal credit
More than \$40,000, but not over \$70,000	43% of federal credit
More than \$70,000 but not over \$100,000	34% of federal credit
Over \$100,000	No California credit

(Rev. & Tax. Code section 17052.6 (b)(2).)

3. FILING REQUIREMENTS FOR CDC CREDIT

A taxpayer who is married or a Registered Domestic Partner (RDP) must file a joint income tax return to claim the California credit. (IRC section 21(e)(2) and California Family Code sections 297 and 297.5.)

However, if a married/RDP taxpayer meets the following requirements, the taxpayer is treated as not married and may claim the credit on a separate return either using head of household filing status or married filing separate filing status. (IRC section 21(e)(4) and California Family Code sections 297 and 297.5.)

- a. The taxpayer lived apart from his or her spouse/RDP at all times during the last six months of the taxable year.
- b. The qualifying person(s) lived in the taxpayer's home more than half of the taxable year.
- c. The taxpayer provided over half the cost of keeping up the taxpayer's home.

ADDITIONAL REQUIREMENTS INCLUDE:

- a. Care services must be provided in California. (Rev. & Tax. Code section 17052.6(e)(1).)
- b. The taxpayer must have earned income to qualify for the credit. If the taxpayer is married or an RDP and files a joint tax return, both the taxpayer and spouse or RDP must have earned income. If the taxpayer (or his or her spouse or RDP) is a student or disabled, the taxpayer or spouse/RDP may be deemed to have earned income. (For further explanation and authorities, see section 11, Deemed Earned Income.)
- c. The taxpayer's spouse or RDP does not need to be the taxpayer's dependent to qualify the taxpayer for the credit, but the taxpayer's child under the age of 13 or a disabled person must be the taxpayer's dependent to qualify the taxpayer for the credit. (IRC section 21(b)(1).)
- d. The qualifying person must live with the taxpayer in the taxpayer's home for more than half the year. (IRC section 21(b)(1).)
- e. The person who provides the care services cannot be the taxpayer's spouse/RDP or the parent of the qualifying person.
- f. The person who provides the care services cannot be a person for whom the taxpayer can claim a dependent exemption credit, or a child of the taxpayer who has not reached the age of 19 years by the end of the taxable year. (IRC section 21(e)(6)(A) and (B).)

- g. If a taxpayer claims the CDC Credit for his or her child, the taxpayer must be the custodial parent. (IRC section 21(e)(5).)
 - h. A taxpayer must incur employment-related expenses for household services or for care of a qualifying person that allowed the taxpayer to work or look for work. (IRC section 21(b)(2).) Full-time or part-time positions qualify as work. Actively looking for work also qualifies as work, but the taxpayer must have *earned income* for the taxable year to be eligible for the CDC Credit.
 - i. A taxpayer must provide the name, address, and taxpayer ID, of the child care or dependent care provider and the amount paid to the care provider on FTB Form 3506. (IRC section 21(e)(9).)
- b. **Age Test** - The child must be under 13 years of age. (IRC sections 21(b)(1)(A) and 152(c)(3).)
 - c. **Residency Test** - The child must live with the taxpayer for more than half the year. (IRC section 152(c)(1)(B).)
 - d. **Support Test** - The child must not have provided more than half of his or her own support during the year. (IRC section 152(c)(1)(D).)
 - e. **Citizenship Test** - The child must be a citizen or national of the U.S., or a resident of the U.S., Canada, or Mexico. (IRC section 152(b)(3).)

4. QUALIFYING PERSON DEFINED

A qualifying person is:

- a. A child under age 13 who meets the requirements to be the taxpayer's dependent as a qualifying child (see section 5 below). A child who turned 13 during the year qualifies only for the part of the year when he or she was 12 years old. (IRC section 21(b)(1)(A).)
- b. The taxpayer's spouse or RDP who was physically or mentally incapable of self-care. (IRC section 21(b)(1)(C) and California Family Code sections 297 and 297.5.)
- c. Any person who was physically or mentally incapable of self-care and either:
 - i. Was the taxpayer's dependent, or
 - ii. Would have been the taxpayer's dependent except that:
 - (1) He or she received gross income greater than the federal exemption amount for the taxable year at issue.
 - (2) He or she filed a joint return
 - (3) The taxpayer or the taxpayer's spouse/RDP, if filing a joint return, could be claimed as a dependent on someone else's return for the taxable year at issue.

(IRC sections 21(b)(1)(B) and 152 and California Family Code sections 297 and 297.5.)

5. QUALIFYING CHILD DEFINED

A qualifying child is a child who meets all of the following tests:

- a. **Relationship Test** - The child must be the taxpayer's birth child, stepchild, grandchild, adopted child, foster child, brother, sister, half-brother, half-sister, stepbrother, stepsister, nephew, or niece. An

6. CHILDCARE PROVIDER REQUIREMENTS

- a. The care provider can be a licensed or unlicensed individual or organization.
- b. The care provider cannot be the taxpayer's spouse/RDP or someone the taxpayer can claim as a dependent on the taxpayer's tax return. (IRC section 21(e)(6)(A); California Family Code sections 297 and 297.5; Treasury Regulation section 1.21-4(a)(3).)
- c. The care provider cannot be the taxpayer's child under age 19, even if the taxpayer's child is not the taxpayer's dependent. (IRC section 21(e)(6)(B).)
- d. An overnight camp is not a care provider (IRC section 21(b)(2)(A)(ii).)
- e. If the qualifying person is the taxpayer's child, the care provider cannot be the child's other parent. However, a person who is the taxpayer's relative but not the taxpayer's dependent may be a care provider even if the provider lives in the taxpayer's home. Care can be provided by a friend, a neighbor, or a relative as long as the relative is not the taxpayer's spouse/RDP and the taxpayer is not entitled to claim a dependent exemption credit for the friend, neighbor, or relative. (IRC section 21(e)(6)(A); California Family Code sections 297 and 297.5; Treasury Regulation section 1.21-4(a)(4).)
- f. In general, any kind of child or dependent care can qualify including care at a center, a family day care home, or a church. (IRC section 21(b)(2)(C) and (D); Treasury Regulation section 1.21-1(e).)

8. NON-QUALIFYING CARE COSTS

- a. If a taxpayer receives free child or dependent care, such as from a state-subsidized program or another person, even if the individual is related to the child, that care cannot be used to qualify for the credit. However, if only part of the taxpayer's child care is subsidized and the taxpayer pays for the rest, the

amount the taxpayer pays can be used to qualify for the credit. The credit is based on the lesser of (1) the actual employment-related care expenses paid by the taxpayer; (2) the taxpayer's earned income or the spouse's/RDP's earned income (if the taxpayer is married or registered with the State as a domestic partner and filed a joint return); or (3) the maximum allowable employment-related care expenses (\$3,000 for one qualifying person; \$6,000 for two or more qualifying persons). (IRC section 21(a)(1), (b), (c), and (d) and California Family Code sections 297 and 297.5.)

- b. Tuition/education expenses for a child in kindergarten or a higher level do not qualify as child care expenses for the CDC Credit. (Treasury Regulation section 1.21-1(d)(5).)

8. CARE COST LIMITS

The California CDC Credit is a percentage of the federal CDC Credit (Rev. & Tax. Code section 17052.6 (b).)

The credit for child and dependent care expenses is refundable for California purposes. If a taxpayer owes state taxes for any taxable year, the credit first is applied to paying the taxes and any remaining amount of the credit will then be refunded to the taxpayer. (Rev. & Tax. Code sections 19301 and 19302.)

- a. The CDC Credit is a percentage, based on a taxpayer's federal AGI, of the amount of employment-related care expenses the taxpayer paid during the year. When calculating the credit, a taxpayer may claim up to \$3,000 of the care expenses paid for one qualifying dependent and up to \$6,000 if the taxpayer has two or more qualifying dependents. However, this amount cannot exceed the taxpayer's earned income, or, if the taxpayer is married as of the last day of the year, the lesser of the taxpayer's or the spouse's earned income. (See section 2 above for the percentage calculation.)

9. SUBSIDIZED DAY CARE

A dependent care flexible benefit plan is a type of plan that includes an agreement to voluntarily reduce your salary in return for an employer-provided fringe benefit. This type of plan gives the taxpayer a choice of whether to receive cash wages or a benefit for dependent care. Because the taxpayer is not paying taxes on the money that is set aside to pay for the dependent care, the taxpayer may not claim the CDC Credit for the dependent care subsidized by the employer flexible benefit plan.

10. EARNED INCOME

Earned income is wages, salaries, tips, or net earnings from self-employment that the taxpayer and his or her spouse/RDP received during the taxable year. The taxpayer's income from pensions, social security, worker's compensation, interest, dividends, unemployment benefits, child support, alimony, and nontaxable workfare payments are not earned income for the purpose of qualifying for the credit. (IRC section 32(c)(2) and California Family Code sections 297 and 297.5.)

If a taxpayer is a military service member domiciled outside of California and earned military compensation during the taxable year, the compensation is considered earned income sourced in California and therefore, is used in computation of the credit. However, care services must be provided in California. (Rev. & Tax. Code section 17052.6(e)(2).)

Under the Military Spouses Residency Relief Act, the earned income of the spouse of a service member is not taxable by California if the spouse and service member are domiciled elsewhere. As a result, if a service member's spouse moves to California with the service member who is stationed in California, and the spouse keeps the same domicile outside California as the service member, the service member and spouse do not qualify for the CDC Credit on their joint California return because the spouse's earned income is not taxable in California. Earned income for purposes of the California CDC Credit is limited to earned income subject to California tax. (Rev. & Tax. Code section 17052.6(e)(2).) The credit is not allowed on a joint California return because it is limited to the lesser of the service member's earned income, whether or not taxable by California, or the spouse's earned income subject to California tax, which is zero. (IRC section 21(d)(1).)

11. DEEMED EARNED INCOME

For each month that the taxpayer's spouse or RDP was a full-time student or disabled, the spouse or RDP is deemed to have earned income of \$250 per month for one qualifying person and \$500 per month if there are two or more qualifying persons). (IRC section 21(d)(2)(A) and (B) and California Family Code sections 297 and 297.5.)

If, in the same month, both the taxpayer and the taxpayer's spouse or RDP were either disabled or full-time students, only one of them is deemed to have earned income in that month. (IRC section 21(d)(2) and California Family Code sections 297 and 297.5.)

The taxpayer's spouse or RDP was a student if he or she was enrolled as a full-time student at an educational organization during any five months of the taxable year. (IRC section 21(e)(7) and (8) and California Family Code sections 297 and 297.5.) An educational organization does not include a correspondence school, unless the correspondence school meets the requirements of an educational organization as defined in IRC section 170(b)(1)(A), which includes, but is not limited to, an educational organization that normally maintains a regular faculty and curriculum and normally has a enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

12. BURDEN OF PROOF

The CDC is a credit. It is well settled by the courts that credits (and deductions) are a matter of legislative grace and the taxpayer bears the burden of establishing entitlement to claimed credits. (*Segel v. Comm'r*, 89 T.C. 816, 842 (1987), citing to *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943); *Appeal of Robert R. Telles*, 86-SBE-061, Mar. 4, 1986.) The concept of legislative grace refers to income that would normally be taxed but is either exempt from tax or subject to a lower tax rate due to special rules. For example, these can be provisions in the law, such as the Internal Revenue Code enacted by Congress or its equivalent at the state level.

The findings of the Franchise Tax Board (FTB) in assessing taxes are presumptively correct. (*Todd v. McColgan*, (1949) 89 Cal.App.2d 509 [201 P.2d 414].) The taxpayer, therefore, has the burden of producing sufficient evidence to overcome the resulting presumption of correctness. (*Appeal of Joseph J. and Julia A. Battle*, 71-SBE-010, Apr. 5, 1971.) This presumption is not overcome by unsupported statements of the taxpayer. (*Appeal of Robert C., Deceased, and Irene Sherwood*, 65-SBE-046, Nov. 30, 1965.) FTB's determination cannot be successfully rebutted when the taxpayer fails to present uncontradicted, credible, competent and relevant evidence as to the issues in dispute. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.)

The taxpayer has the burden of producing sufficient evidence to establish that he or she is entitled to the credit.

a. To assist in meeting this burden, the taxpayer should take care to secure the appropriate documentation (copies of government issued identity documents, social security numbers or Federal Employer Identification Numbers (FEIN) at the time the taxpayer is securing the care provider's services, in case such documentation is necessary to prove the

identity of the care provider and to prove that the care provider meets the legal definition used for a care provider. (IRC section 21(e)(9) and see section 6 above.)

- b. A taxpayer must supply information about the provider by completing Part II of FTB Form 3506, which the taxpayer must attach to his or her state income tax return. Form 3506 requests that the taxpayer supply the provider's name, address, social security number or FEIN. (IRC section 21(e)(9).) In order to process the taxpayer's CDC Credit claim, Form 3506 also requests that the taxpayer supply the provider's telephone number, the address where the care was provided, and the amount the taxpayer paid the provider to supply care services during the year.
- c. To meet the burden of proof, the taxpayer may be required to supply evidence to show that care services were provided and paid for (Treasury Regulation section 1.21-1(k)) and that the care provider meets the legal requirements. Therefore, securing appropriate records will assist the taxpayer in meeting this burden of proof. If a taxpayer cannot establish with verifiable and reliable documentation that he or she meets all of the legal requirements, then the taxpayer may not be allowed the CDC Credit. Evidence that will assist a taxpayer in meeting the burden of proof includes, but may not be limited to:
 - i. A notarized statement signed by the provider *under penalty of perjury* in which the provider supplies the amounts received from the taxpayer for the care of each child or dependent during the year.
 - ii. An invoice issued by the provider (if the provider is a school or licensed day care provider, not an individual) that shows the amounts received from the taxpayer for the care of each child or dependent during the year.
- d. Independent Notary:
 - i. When asked for a statement to be notarized, the taxpayer should use an independent notary; i.e., a notary that does not have a *working relationship* with the tax preparer and/or practitioner.
 - ii. The identity of the person making the notarized statement must be verified by the notary based on specified documents such as a current and valid driver's license.
- e. The taxpayer may be requested to provide identification of the care provider by supplying a copy of the provider's social security card and a picture ID. Acceptable forms of picture ID include a driver's license, DMV ID card, or U.S. Passport.
- f. The taxpayer may be requested to provide evidence to show that he or she paid the care provider for the care services claimed. The taxpayer may provide

either copies of cancelled checks or money orders made out to the provider, or copies of invoices and/or receipts issued by the provider at the time the service was provided. Taxpayers will be asked to provide receipts which show the provider's name, the period for which care was provided, the amount the taxpayer paid, the name of the person for whom care was provided, and the provider's signature.

- g. The taxpayer may be requested to show a copy of the custody agreement (where custody of a qualifying child is split between the parents).
- h. FTB may request information regarding the taxpayer's California income tax return within the California statute of limitations period, which is usually the later of four years from the due date of the return or the date the return is filed. (Exception: an extended statute of limitations period may apply for California or federal tax returns that are related to or subject to a federal audit).

In general, it is recommended that a taxpayer keep a copy of his or her return and the records that verify the income, deductions, adjustments, and the claimed *CDC Credit* reported on the return for four years.

If the provider cared for the taxpayer's qualifying child or claimed dependent in the taxpayer's home, the taxpayer may be a household employer. If the taxpayer is a household employer, the taxpayer may have to withhold and pay social security, Medicare tax and federal unemployment tax for the provider.

- j. Taxpayers are responsible for knowing and following state and federal employment laws which are generally applicable to paid care providers, including in-home child care providers.