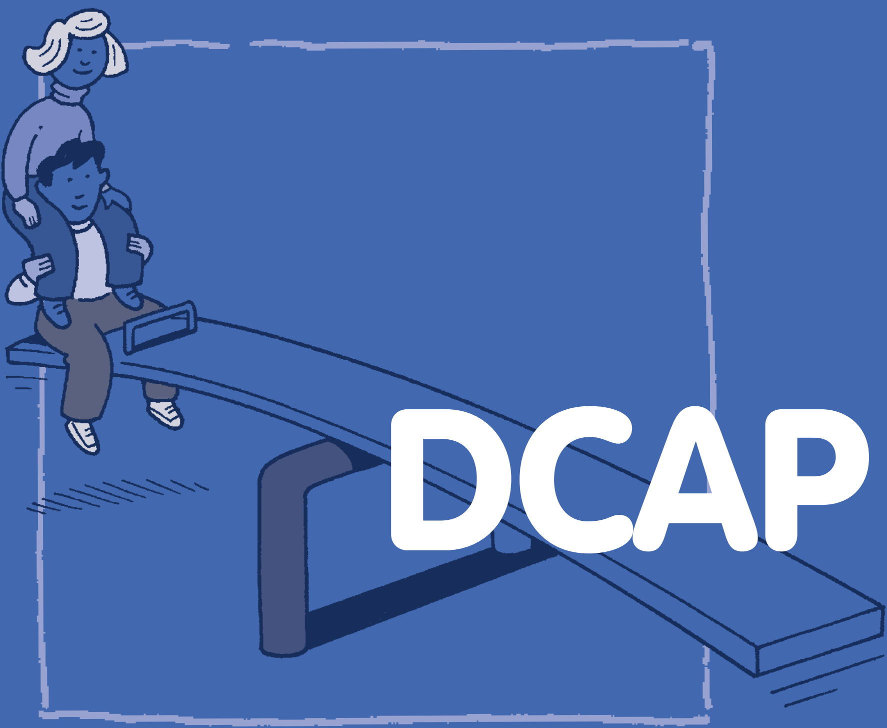
Use This Important Tax Benefit to Save Money on Your Child and Dependent Care Expenses



An Employee's Guide
to Dependent Care Assistance Programs (DCAPs)

1 Getting Started with Dependent Care Assistance Programs (DCAPs)

A Dependent Care Assistance Program (DCAP) is a flexible spending account that your employer offers to help you pay for your child or dependent care expenses. It is much like the account that you may already use to pay for some of your out-of-pocket health care expenses.

How a DCAP works

Under a DCAP plan, you can set aside up to $5,000 of your annual income to help cover the cost of:

- child care,
- elder care, or
- care for a disabled spouse or disabled dependent.

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.

But DCAPs come with rules about:

- the *qualifying ages and situations* of children or adult dependents who receive the care; and
- the kinds of care that qualify for the reimbursement.

The child (under age 13) or adult who receives the care must live with you during the tax year when your DCAP is in effect *and* you must claim that child or adult as a dependent on your tax return for that year.

The care you choose can come in a wide variety of packages: care in a preschool, nursery school, child care center, or family child care home, or for a babysitter or nanny who comes to your home. You can also pay for before- and after-school care, summer and holiday day camps, and the registration fees for these kinds of programs. Most types of child and dependent care qualify as long as the care is needed for you to work. If you are married, both you and your spouse must be working or looking for work, or one spouse must be a full-time student, or incapable of self-care.

How a DCAP can save you money

You save money because you do not pay federal income tax or Social Security and Medicare taxes on the amount you set aside. You may also save some money on your state and local income taxes by participating in a DCAP, depending on where you live. The savings to you is the amount you *would have* paid in taxes if your salary had not been reduced. Depending on your income, you could save more than $2,000 a year. Your company or plan administrator may offer an on-line calculator or "flexible spending account estimator" that will help you figure out your tax savings. If not, there are several calculators available on the Internet.

Participation in a DCAP may also help you qualify for the federal Earned Income Tax Credit (EITC) or may increase your EITC. That's because DCAP participation lowers the taxable income used to calculate eligibility for the EITC and to calculate the amount of the EITC. Eligibility for the EITC depends on your family income (generally under $40,000 for a married couple with two or more dependent children), number of dependents, and filing status (single, married, etc.). For more information on the EITC, see http://www.irs.gov.

3

Deciding on your DCAP contribution

It's up to *you* how much money to put into your DCAP account for the year. Keep in mind, though, that you won't get a refund for any money that you don't use during the plan year. This is sometimes referred to as the "use it or lose it" rule. But compared to estimating the amount to set aside in a flexible spending account for health care, it's much easier to predict your child or dependent care costs. And with the current ceiling of $5,000 on what you can put into a DCAP, chances are excellent that there won't be any money left over.

Note, too, that your employer has a list of what are called Qualifying Life Events, which are changes in your situation that are relevant to the DCAP: for example, a change in the number of your dependents or a change in provider. Under some circumstances, the change can lead to a modification in the amount of your DCAP for that year.

Receiving reimbursement from your DCAP

For a DCAP, you can withdraw up to the amount that is in your account at that time. That means in the beginning of the plan year, you may have to wait several pay periods before there is enough in your account to reimburse you for the payments you may have already made. Once you have sufficient funds, submit a claim form to your company's plan administrator. Along with the form, you'll need to include a receipt of what you have paid, including the address and Social Security number or taxpayer identification number of the caregiver.

While claims can be submitted anytime during the plan year, including a period of time called the run-out or grace period (generally about 2 ½ months after the end of the plan year), it's good practice to set a regular schedule to submit your claims and receive your reimbursements. Your company's plan may have requirements for how often you can submit a claim.

Claims are generally processed within 3-10 days and some plans have ways of speeding up the reimbursement process. For instance, the plan administrator may make a direct deposit of the money into your bank account (just like a paycheck). Or you may be able to submit claims online for a quicker turnaround time, rather than having to mail in your request. Check to see if these options are available to you.

Making the best decision for you and your family

Before making any decisions about your taxes, you may want to consult your accountant, a tax specialist, or read more about these programs on the IRS web site (www.irs.gov, especially see Publication 503, Child and Dependent Care Expenses).

You will also want to consider another federal tax benefit, the Dependent Care Tax Credit (DCTC):

- The eligibility criteria for the DCTC and the DCAP are very similar, but the expense limits are different: in a DCAP you can claim up to $5,000 in expenses; for the DCTC you can claim up to $3,000 for one child or dependent and up to $6,000 for two or more.
- Another difference between the DCTC and the DCAP is that the DCTC is claimed after the end of the tax year, when you file your federal tax return.
- If you participate in a DCAP, you will not be able to claim the full (or perhaps any) amount of the DCTC. That's because you must subtract any expenses reimbursed through your DCAP when you calculate your expenses to claim the DCTC.

Here's an example of how that works:

- Let's say you have one child and $5,000 set aside in a DCAP. In that case, you cannot claim the DCTC because the DCTC ceiling is $3,000 for one child.
- But suppose you've set aside that same $5,000 in the DCAP and have $7,000 in child care expenses for two children. Then you can claim the DCTC for $1,000. Why? After you've subtracted the $5,000 in the DCAP from your total of $7,000, you still have $2,000 left in expenses. And $1,000 of that total falls below the DCTC ceiling of $6,000 for two children.

If your family situation and the amount of your child care expenses permit you to use a combination of a DCAP and the DCTC, you may be able to maximize your tax savings.

Even if you can't use both the DCAP and the DCTC, most families—particularly families that have over $40,000 in adjusted gross income—are better off using the DCAP than relying only on the DCTC. But families with adjusted gross income between $30,000 - $40,000 or families with adjusted gross income below $14,000 - $15,000 (depending on their filing status) will probably save more in taxes claiming the DCTC.

You may be able to make a rough comparison of your own tax savings claiming the DCAP or the DCTC. Use your company's or plan administrator's income calculator to figure your federal tax savings using a DCAP; then use the IRS Form 2441 (Child and Dependent Care Expenses) to calculate what you could potentially save claiming the DCTC.

Finally, if you can't use both the DCAP and the DCTC and it's a close call which one to choose, here's one reason to decide on the DCAP: you are reimbursed only once a year for your expenses if you use the DCTC—when you get your federal tax refund—but you get your money back much more regularly using a DCAP.

Tips on How to Make DCAPs Work for You

Organize your information.

At the beginning of the year, make a file or get a special folder to organize your invoices and receipts for your child and dependent care expenses. Keep the information you will need to report on your providers here, too. For every provider that you use, you must submit: 1.) a completed Form W-10, *or* 2.) a copy of the provider's Social Security card, *or* 3.) a printed invoice with the provider's name, address, and taxpayer identification number.

Set a regular schedule for submitting reimbursements and stick to it.

Avoid having your folder bulge with those receipts! Few things can be more discouraging than tackling mounds of paperwork. But if you claim reimbursements regularly, you won't face that problem — plus you'll get money back in your pocket with minimum delays. Check your company's plan to find out when, and how often, you can submit a claim form. Pick a time period (semi-monthly, monthly, quarterly) that works for you and conforms with your plan requirements, and enter those dates for the year in your organizer or calendar.

Check your account balance periodically.

At least quarterly, you will want to see how much remains in your account and to monitor your reimbursements and claims. Some plan administrators allow you to do this on-line, so check to see if this feature is available to you.

7 Take advantage of what the plan administrator offers.

Your company's plan administrator may offer a number of services to help you get the most out of your DCAP. Those services may include: an on-line calculator to estimate your tax savings, on-line submission of your claim forms, automatic payment of unpaid claim balances, direct deposit of your reimbursement to your bank account, and the ability to check your account balance on-line. Spend a little time on the plan administrator's website or contact the plan administrator (directly or through your human resources department depending on company policy) to become familiar with the benefits that are provided.

Become familiar with the specifics of what your company's plan allows.

While many of the specifics of flexible spending accounts must comply with IRS requirements, companies have some leeway in determining which Qualifying Life Events will be part of their plans, and whether or not they will offer some time after the plan year (a grace or run-out period) during which you can still submit receipts and receive reimbursement. Your company's DCAP plan may be available on your intranet, or ask your human resources department or plan administrator for a copy. Knowing the Qualifying Life Events that your company allows will help you if you find you need to make a change in your DCAP contribution.

Once you know the final date when you can submit a claim, make a note on your calendar or PDA at least several weeks before then and check to make sure you have used all the funds in your account. If not, find that last receipt and submit it now!

Tell Me More: Frequently Asked Questions about DCAPs

You've explained that many different kinds of child care qualify for a DCAP — not just care for very young children — but before- and after-school care and summer and holiday day camps, too. Are there any kinds of child care that don't qualify?

Yes. You can't use a DCAP to pay for kindergarten, summer school tuition, overnight camp, or generally for lessons, with the exception of lessons that can't be separated from the cost of care. *Au pairs* (foreign caregivers on J-1 visas hired through a federally sanctioned program) are generally not accepted as eligible providers under most company DCAPs.

My only child care expenses are for summer day camp. Why should I use a DCAP?

When it's April and time to enroll your child in day camp, you'll probably be glad you decided to participate in your company's DCAP. Many parents who have not put savings aside to pay for the high cost of camp (an average of $270 per week according to the American Camping Association), find it difficult to take the extra money out of the family's weekly budget. But you allowed for camp fees when you decided on your DCAP contribution. Now the money that you began to set aside in January is there for you to use for your child's care in the summer.

I have a 15-year-old child who is developmentally disabled and can't care for herself after school. Can I use a DCAP to pay for her caregiver?

Yes. If you have a dependent — either a child, spouse, or parent — who has physical or mental disabilities that make them unable to care for themselves, you can use a DCAP to pay for that person's care. But remember: the care must qualify under IRS guidelines and the person needing care must live with you and be claimed on your income tax return as a dependent for the year you use the DCAP.

You're talking about signing up for a DCAP for a year. Is that a year from whenever I decide to start?

Generally, no. You will have the opportunity to sign up for a DCAP during your company's annual *open enrollment period*, when you choose or re-elect your benefits, or if you are a new employee, within a specified timeframe after you begin employment at the company. You may also be eligible to begin participation in a DCAP if your family circumstances change during the year. As mentioned earlier, DCAP plans come with a list of Qualifying Life Events, and if you experience one, you may be able to change the status of your participation. Check your company's plan to understand what qualifies as a life event.

Once I sign up for a DCAP do I have to re-enroll every year?

Yes. You must actively enroll for the new plan year if you want to participate in the DCAP program. Your previous year's elections do not automatically carry over into the next year. Use the open enrollment period to estimate your child and dependent care expenses and choose the amount you would like to set aside for the coming year.

My spouse's employer also offers a DCAP program. Can we both participate?

Yes, but the amount you set aside cannot exceed $5,000 per family each year. If you are married and filing separate tax returns, each spouse can set aside up to $2,500 annually. If your company has a program that provides subsidized contributions to the DCAP, this limit applies to the employer and employee contribution, combined.

In addition to the DCAP, my company also offers a flexible spending plan for health care. What's the difference and can I enroll in both?

Many companies offer flexible benefits programs for child and dependent care expenses and another program for eligible health care expenses. The health care account allows you to pay for many out-of-pocket medical expenses, such as co-pays under your health care plan, eyeglasses and contact lenses, and many over-the-counter products. It operates in much the same way as your DCAP (you set aside a designated amount each pay period and that money is not subject to federal income and payroll taxes). Your company's benefits plan will include more information on the specifics of the health care account.

Depending on your family's needs, you can enroll in the DCAP alone, the health care program alone, or in both programs. However, you cannot transfer money between these two accounts (for example, you can't be reimbursed from your health care account to pay for any child care expenses). Also both accounts require that you incur and claim the expenses during the plan year (or grace period if your plan has one) or you lose access to the funds.

Doesn't the "use it or lose it" rule make putting money in a DCAP an iffy choice for me?

Not really. Most families spend considerably more than $5,000 to pay for child care in a year. According to the 2008 Update to *Parents and the High Price of Child Care* prepared by the National Association of Child Care Resource & Referral Agencies, the average price for infant care ranges from $4,000 to over $14,000 annually depending on where you live. Also, child care costs are more predictable than health care costs, so most families can readily estimate what their expenses are going to be for the coming year. In addition, as noted, the IRS and companies' plans include a number of Qualifying Life Events that allow you to change the amount you contribute to a DCAP. These may include a change in employment for a spouse or a change in provider. You probably even have a period early in the following calendar year to submit your claim for reimbursement. Check with your company's benefits department or plan administrator to make sure that you understand your company's Qualifying Life Events as well as the time period you have available to use your DCAP funds and submit claims.

According to several administrators of these programs, most people do not leave any significant amounts of unspent funds in their accounts. But of course, to make sure that doesn't happen, you do need to keep track of your receipts, check your account periodically to see how much remains, and file your claims in a timely manner.

My child care arrangements might change during the year that I set aside DCAP money. Or I could move or have a new baby. What then?

As stated above, DCAP plans come with a list of Qualifying Life Events, and if you experience one, it's up to you to notify your employer, or the company that handles these benefits for your employer. Your company's plan will list the specific events that would be considered, but typical Qualifying Life Events include:

- change in your marital status;
- change in your number of tax dependents — for instance, a new baby;
- change in the eligibility of the child or other dependent for the DCAP—for instance, a child turns 13;
- change in cost of the care or the amount of care you're using;
- losing or quitting a job or another employment change that would affect your eligibility for the DCAP.

What happens if the care I'm using gets more expensive and it would be helpful to claim a bigger DCAP? Can I do that?

Maybe. Of course, during the open enrollment period, you can increase your DCAP amount (anywhere up to the ceiling amount of $5,000) for the coming year. But once the open enrollment period has ended, you usually must stay with the amount you signed up for, unless your change in the cost of care is on the list of Qualifying Life Events for your company's plan. Check with your employer, because some company plans do allow that kind of change.

Last year I filed for a Child Tax Credit on my federal income tax. Will using a DCAP make me ineligible for that credit?

No. You can receive the federal Child Tax Credit (CTC)—which can be worth as much as $1,000 per child—whether or not you use the DCAP. The CTC is not affected either by the amount of your child care expenses or participation in a DCAP.

Do I have to report using a DCAP to the IRS?

Yes. Although DCAP benefits are provided through your employer, you must report the receipt of the benefit on your federal tax return.

My babysitter does not want to give me her Social Security number. What should I do?

If you have asked for your provider's Social Security number (or taxpayer identification number) and your provider refuses to give you that information, you will need to report on your federal tax return that you requested the information but were refused by the provider.

What's the effect of using a DCAP on my state and local income taxes?

Using a DCAP may lower both your state and local income taxes, depending on where you live. In some states, you may save more in taxes if you claim the federal Dependent Care Tax Credit *and* your state child and dependent care tax benefit. You should become familiar with your state's child and dependent care tax benefit program and its effect on your taxes before deciding to participate in a DCAP. For more information on what your state offers, check with your state's tax agency. The National Women's Law Center www.nwlc.org also has materials and other resources on state-level child and dependent care tax provisions.

How can using a DCAP help me purchase higher quality care for my child?

We all want the best possible care for our children, and the reality is that in most cases, higher quality child care costs more. But not necessarily that much more. A 2008 study shows that in many states the difference in the cost of a child care center that is accredited by the National Association for the Education of Young children (an accepted benchmark for high quality care) and the cost of a non-accredited center can be less than $500 a year. Using a DCAP will make your child care dollars stretch farther and just may help you make up the difference in cost — not to mention the peace of mind you will gain knowing your child is happy and well cared for.

Funding for this guide was provided by Deloitte & Touche, Exxon Mobil Corporation, IBM Corporation, Johnson & Johnson, and Texas Instruments through the American Business Collaboration.

ABC
American Business Collaboration for Quality Dependent Care

The American Business Collaboration is managed by WFD Consulting (www.wfd.com)

This guide is available at www.abcdependentcare.com