CHAPTER 1

New Rules for Your Home and Family

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The housing market in the past several years witnessed unprecedented foreclosures and declines in property values. The tax law has been used to stimulate home purchases as well as provide relief for those who have lost their homes. Another force at work is energy and its impact on heating, cooling, and lighting your home. Tax law again comes to the rescue to encourage "greening" your home.

Within your home is your family, and the tax law provides new breaks for you, no matter how you define the term "family." Whether you are a single parent, empty nester, or part of a two-parent household with the old 2.3 children, you may qualify for new or expanded tax breaks in 2010 and beyond.

This chapter covers the new rules that affect your home and your family in 2010. It also discusses possible changes to come in 2011 so you can plan ahead.

Tax Credit for Homebuyers

You may be entitled to a tax credit if you purchased a home within a set time limit. The deadline for the credit was April 30, 2010. However, those in contract for a purchase on that date can qualify for the credit if they closed on the home by September 30, 2010. If you built a home, occupancy is treated the same as

closing on the home for purposes of the credit; you must have moved in before October 1, 2010, to be eligible for the credit.

There are two main credits you may qualify for:

1. First-time homebuyer credit of up to $8,000 ($4,000 for a married person filing separately). To qualify, you (and your spouse) must not have owned a home within three years of the date of purchase.
2. Long-term resident credit of up to $6,500 ($3,250 for a married person filing separately). To qualify, you (and your spouse) must have owned the home you are disposing of to buy a new one for five consecutive years during the eight-year period ending on the date of sale.

For either credit, you also must meet each of the following conditions:

- Your modified adjusted gross income (essentially your adjusted gross income without any foreign earned income exclusion) cannot exceed set amounts, as explained later.
- The buyer cannot be a dependent or under age 18 (unless married to someone at least 18).
- The buyer must attach a copy of the settlement statement to his or her return.
- The home cannot cost more than $800,000.
- The home must be located in the United States; foreign homes do not qualify.

To claim the full credit, your modified adjusted gross income (MAGI) must be below set limits. Table 1.1 shows the MAGI phaseout range; those with MAGI below the range can claim the full credit. Those with MAGI above the range cannot claim any credit.

TABLE 1.1 MAGI Phaseout Ranges for the First-Time Homebuyer Credit

Filing Status	Phaseout Range
Single	$125,000 to $145,000
Married filing jointly	$225,000 to $245,000

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Example

A married couple filing jointly have MAGI in 2010 of $235,000. They buy their first home in April 2010. They can claim a reduced credit of $4,000 (half the otherwise allowable credit) because they are midway through the phaseout range. If their MAGI were under $225,000, they could claim the full credit; if it were over $245,000, they could not claim any credit.

The credit applies without regard to the amount of financing on the home. For example, there is no minimum (or maximum) down payment required for the purchase of a home with respect to the first-time homebuyer credit.

The credit can be claimed by an eligible home buyer even if there is a cosigner who guarantees the mortgage.

The credit does *not* apply if you purchase the home from a "related person." Related persons include a taxpayer's spouse, ancestors (e.g., parents and grandparents), and lineal descendants (e.g., children and grandchildren). A beneficiary of an estate who buys the decedent's residence from the estate's executor is considered a related person to the executor and the sale will not qualify for the credit. ***Exception:*** If the sale satisfies a pecuniary bequest by the decedent to the beneficiary, which is a cash bequest, then it can qualify for the credit.

Homebuyers who live in the District of Columbia had another credit option for 2009: the D.C. homebuyer credit. This credit, which was limited to $5,000 ($2,500 for a married person filing separately), applied if you bought a principal residence in the District of Columbia and you (and your spouse if married) had not owned a home within one year of the purchase. You could not claim the credit if your MAGI was $90,000 or more ($130,000 or more if married filing jointly); a partial credit was allowed if MAGI was between $70,000 and $90,000 ($110,000 and $130,000 if married filing jointly). No credit was allowed if you previously claimed this credit for a different home. The D.C. homebuyer credit could be claimed if a homebuyer was eligible for the regular first-time homebuyer credit.

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The D.C. homebuyer credit does not apply after 2009 unless Congress extends it; check the Supplement for details.

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Claiming the Credit

The homebuyer credit for first-time homebuyers and long-term residents is refundable, which means you can receive the credit even though it is more than your tax liability for the year.

Special rules apply when two or more unrelated buyers purchase a home. A single credit applies per residence, so if two or more unrelated buyers acquire a principal residence together, the credit must be allocated among those who qualify (i.e., meet the "first-time" homebuyer requirement and MAGI limits) using any "reasonable method." The IRS says a reasonable method can be based on:

- Contributions toward the purchase price of the home as tenants in common or joint tenants.
- Ownership interest in the home as tenants in common.

Example

Assume two people who aren't married to each other and who are both first-time homebuyers with MAGI below the phaseout level buy a home together in February 2010. One contributes $45,000 and the other $15,000 toward the purchase price of $60,000. Each owns one-half of the residence as tenants in common. The top credit is $6,000 (10 percent of $60,000), which can be allocated three-fourths to the $45,000 contributor ($4,500) and one-fourth to the $15,000 contributor ($1,500), or one-half ($3,000) to each based on their ownership interests in the residence.

Example

Same facts as the preceding example except that each owner's contribution was merely part of a $60,000 down payment on a home costing $600,000. The maximum credit in this case is $8,000 (10 percent of $600,000, but no more than $8,000). The credit of $8,000 can be allocated three-fourths to the $45,000 contributor ($6,000) and one-fourth to the $15,000 contributor ($2,000), or one-half ($4,000) to each based on their ownership interests in the residence.

If any of the unrelated purchasers do not meet eligibility requirements (e.g., their MAGIs are too high), the entire credit can be allowed to the one or more purchasers who do meet the requirements.

Example

Same facts as the preceding example except that the person contributing $45,000 has MAGI of $150,000. Since this contributor is not eligible for the credit, the entire $8,000 can be claimed by the $15,000 contributor.

The credit is claimed on Form 5405, *First-Time Credit and Repayment of the Credit* (see Appendix C). You must attach to this form a copy of your settlement statement (usually the Form HUD-1, *Settlement Statement,* will do).

Anyone who purchases a residence in 2010 and qualifies for the credit can opt to claim the homebuyer credit on a 2009 return. Amending a 2009 return to take advantage of this option means receiving the tax benefits of the credit that much sooner.

Recapture

If you purchased a home in 2009 or during the qualifying period in 2010 for which a credit has been claimed and you sell the home within 36 months or cease to use it as your principal residence during that period, then the full amount of the credit must be repaid for the year in which the home ceases to be a principal residence.

Recapture of Pre-2009 Credits

If you purchased a home on or after April 9, 2008, and before January 1, 2009, and claimed a first-time homebuyer credit, then 2010 is the first year in which you must begin to “recapture” the credit by adding back 1/15 of it to your tax return for 2010 (it is reported as “Other Taxes” on your return). For example, if you claimed the full $7,500 credit on your 2008 return, you must add back $500 (1/15 of $7,500) on your 2010 tax return.

You figure the recapture amount on Form 5405 (see Appendix C).

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Before you sell a home purchased in 2009 or 2010 for which you claimed a credit, keep in mind that there's a 36-month waiting period before you escape recapture of the credit. If you bought your home on November 1, 2009, for example, you won't have any income from adding back the credit if you delay a sale until after November 1, 2012 (36 months from the purchase date).

Home Energy Credits

You can get triple benefit from making certain energy improvements to your home: You save on energy costs, improve the value of your home, and can reduce your tax bill by claiming a tax credit.

There are two types of home energy credits:

- "Nonbusiness energy property" credit for adding insulation, storm windows and doors, or energy-efficient heaters and central air conditioning. This credit applies only for improvements made by the end of 2010. The maximum credit is 30 percent of costs up to an aggregate of $1,500 (taking into account any credit claimed for such improvements made in 2009).
- "Residential energy property" credit for renewable energy improvements such as solar panels, geothermal heat pumps, wind energy property, and fuel cells. This credit is 30 percent of costs, with no dollar limit; it applies for improvements made through 2016.

Figure the credit on Form 5695, *Residential Energy Credits* (see Appendix C).

Note: You must reduce the basis of your home by the amount of any energy credit you claim. This will have the effect of increasing gain when you sell the home. However, the basis reduction may not make any tax difference if the full amount of gain (even after basis reduction) is less than the home sale exclusion, which is gain up to $250,000 ($500,000 on a joint return).

PLANNING

Not every improvement that would seem to be an energy saver qualifies for the credit. For example, the IRS has said that insulated vinyl siding does not qualify for the credit. Before making an improvement, check with the manufacturer (a dealer can provide a certificate of qualification for certain types of

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improvements). Also view improvements eligible for the credit at ENERGY STAR (www.energystar.gov) (not all products bearing the ENERGY STAR label qualify for the credit).

Also check for state income tax breaks at DSIRE (www.dsire.org and click on your state).

Appliance Rebates

The American Recovery and Reinvestment Act of 2009 funded a state-run rebate program to the tune of $300 million. If you purchased ENERGY STAR appliances for your home in 2010 under your state's program and received a rebate, you are not taxed on the rebate. The rebate under this program is tax free to you.

The rebate program in most states began in late winter or early spring and can continue until funds run out (but no later than February 2012). Only appliances purchased within your state's timeframe can qualify for a rebate. The type of appliances that could be covered include boilers, central or room air conditioners, clothes washers, dishwashers, furnaces (oil and gas), heat pumps (air source and geothermal), refrigerators and freezers, and water heaters.

Check with your state to see time limits and eligible appliances through the Department of Energy Web site at www.energysavers.gov/financial/70022.html.

Real Estate Taxes

Usually, local property taxes on your home, vacation home, or other personally held realty are claimed as an itemized deduction. This continues to be true; there is no cap on the number of homes for which you can deduct all of your local property taxes.

In 2009, you could have opted to deduct up to $500 if single, or $1,000 if a joint filer, as an additional standard deduction amount. This rule was in effect to help home owners who did not itemize their personal deductions.

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This break does not apply after 2009 unless Congress extends it; check the Supplement for details.

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Emergency Responders

Volunteer firefighters and emergency medical responders can exclude from their income state or local property tax benefits up to $30 per month (a maximum of $360 per year). The benefit can be in the form of a tax reduction or tax rebate. In most places, the tax break is tied to home ownership in the form of a property tax reduction or rebate.

Alert

This break runs only for 2008, 2009, and 2010, unless it is extended; check the Supplement for details.

Cancellation of Mortgage Debt

You may be "underwater" with your mortgage (what you owe is more than your home is now worth). If some or all of the remaining balance on the loan is forgiven because of a foreclosure, a mortgage workout, or a short sale (which avoids the need for foreclosure), the amount forgiven usually is treated as taxable income. However, under a special rule for a principal residence, such debt forgiveness is not taxable.

To be tax free, the debt must have been used to buy, build, or substantially improve your main home and the debt must have been secured by the home (this is called "qualifying debt"). If the debt was refinanced, the amount qualifying for this break is limited to the mortgage principal immediately before the refinancing. The limit on qualifying debt is $2 million ($1 million for a married person filing separately).

The lender will issue a Form 1099-C, *Cancellation of Debt*, reporting the mortgage forgiveness and the portion that is not taxable. Then you must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness* (see Appendix C), to report the transaction on your income tax return for the year of the debt forgiveness.

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This break applies only to qualified debt forgiven on a main home in 2007 through 2012. The break does not apply to a mortgage on a second home, rental property, or business property.

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Even though your home has been foreclosed upon, you may still have to recognize gain from the foreclosure sale if the amount realized (the fair market value of the home, as reported to you in Box 7 of Form 1099-C) is more than the basis of your home. This gain is *not* forgiven as is debt cancellation. If you have a loss on the foreclosure (the fair market value is less than your basis), you cannot deduct the loss, because it is a nondeductible personal loss.

Losses on the Sale of a Residence

While the housing market is showing signs of improvement, many sellers may still wind up losing money. It is a fact of tax law that you cannot deduct losses on the sale of a principal residence. This is considered a personal asset and no losses are allowed on the sale or exchange of personal assets.

Alert

There have been some suggestions that Congress reverse this result to allow homeowners to claim their losses on their tax returns. So far, there have been no positive developments on deductibility of a loss on the sale of a residence; check the Supplement for details.

Moving Expenses

The U.S. Census Bureau says about 34 million Americans move each year—some locally and others to distant locations. If you relocate because of a change in employment or self-employment, you may qualify to deduct your moving expenses. Most of the tax rules for the moving expense deduction, which can be claimed whether or not you itemize your other personal deductions, have not changed. Still, it is a valuable write-off. There is no dollar limit and the deduction does not depend on your income.

To be eligible for this deduction, the distance between your new job or business and your former home must be at least 50 miles more than the distance between your old job or business and your former home. Also, you must work in the locality of the new job as a full-time employee for at least 39 weeks (78 weeks if you are self-employed in your new location). If you are moving to pursue your first job out of school or are returning to the workforce full time after a long period of unemployment or part-time work, the new job location must be at

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least 50 miles from your former home. You can't deduct moving expenses if you are relocating because of retirement.

If you're eligible to deduct moving expenses and you use your car, van, or pickup truck to move household goods and/or your family, you can deduct your actual costs or a standard mileage rate set by the IRS. For 2010, the standard mileage rate is 16.5 cents per mile (in 2009 it was 24 cents per mile). Whether you deduct actual expenses or the standard mileage rate, you can add parking and tolls to your deduction.

PLANNING

If your new employer pays or reimburses you for the move, you are not taxed on the reimbursement as long as you could have deducted your moving expenses if you hadn't received reimbursement. Of course, you cannot also claim a deduction for the expenses that were reimbursed.

Personal and Dependency Exemptions

You can take an exemption for yourself (your spouse can claim an exemption, too), plus an exemption for each dependent. For 2010, the exemption amount is $3,650, the same as it was in 2009.

No exemption can be taken by a taxpayer who is eligible to be claimed as a dependent on another taxpayer's return. Thus, for example, if your dependent child files a tax return to report his income, this child (who is your dependent) cannot claim any personal exemption; you can claim a dependency exemption for your child even though he files a tax return (as long as you meet the dependency requirements that follow).

What is new for 2010 is the fact that there is no phaseout of the exemption for high-income taxpayers. You may recall that in 2009, if your modified adjusted gross income exceeded a set limit, the top exemption amount after the phaseout was only $2,433.

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For divorced, separated, or unmarried parents, the exemption for the couple's child usually belongs automatically to the custodial parent. (The parents cannot split the exemption amount between them.) However, if the custodial parent wants to permit the other parent to claim the exemption, the custodial parent

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must sign Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent*. For post-2008 divorces or agreements, the parent cannot simply attach pages of a decree showing which parent is entitled to the exemption.

The old phaseout for personal exemptions in place prior to 2006 is set to return after 2010, unless Congress changes the law. This may affect decisions in matrimonial situations where parents are deciding which one should claim a dependency exemption for their child.

Earned Income Credit

Low-income earners may be eligible for a credit that encourages them to work. The credit is refundable—it can be paid to the taxpayer even if it exceeds the amount of tax for the year. In effect, it is a negative income tax designed to put money back into the pockets of low earners. However, this credit is highly complicated and produces more errors on tax returns than just about any other provision in the tax law. For example, some taxpayers assume they must support a child in order to claim the credit, but in reality the credit is available to low earners regardless of whether they have a qualifying child.

For 2010, there are changes to the earned income credit because of adjustments for inflation.

Maximum Credit

The amount of the credit you can claim depends on the number of qualifying children you have, if any, and your income. Cost-of-living adjustments to the credit amounts mean that a higher credit may be claimed in 2010 than in 2009 for many qualifying individuals. Table 1.2 shows the top credit for 2010 as compared with the top credit for 2009.

TABLE 1.2 Maximum Earned Income Credits

Number of Qualifying Children	Top Credit in 2010	Top Credit in 2009
None	$ 457	$ 457
One	3,050	3,043
Two	5,036	5,028
Three or more	5,666	5,657

Income Limits

The top credit applies only for those with earned income or adjusted gross income (AGI) that is above a specified amount but does not exceed a threshold phaseout amount. For 2010, the phaseout range for all married filers is increased; thus they can have more income without losing the credit. In order to understand the phaseouts, you need to know the following definitions:

- "Earned income amount" is the amount of earned income at or above which (up to the threshold phaseout amount) the maximum credit can be claimed. Earned income does not include any nontaxable benefits (e.g., elective deferral contributions to 401(k) plans and employer-paid educational assistance). Effectively, earned income is the amount reported as wages on an employee's W-2 form or, for self-employed individuals, the amount reported as net earnings from self-employment. For those in the military, earned income can include combat pay if they so elect.
- "Threshold phaseout amount" is the greater of AGI or earned income above which the maximum credit starts to phase out.
- "Completed phaseout amount" is the greater of AGI or earned income at which no credit can be claimed.

Table 1.3 shows the earned income phaseout ranges for the earned income credit in 2010. In most cases, these are higher than the ranges for 2009.

TABLE 1.3 Earned Income Credit Limits

	Number of Qualifying Children			
Item	**One**	**Two or More**	**Three or More**	**None**
Earned income	$ 8,970	$12,590	$12,590	$ 5,980
Threshold phaseout amounts (single, head of household, surviving spouse)	16,450	16,450	16,450	7,480
Completed phaseout amount (single, head of household, surviving spouse)	35,535	40,363	43,352	13,460
Threshold phaseout amounts (married filing jointly)	21,460	21,460	21,460	12,490
Completed threshold amounts (married filing jointly)	40,545	45,373	48,362	18,470

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A number of rules for the earned income credit are set to expire at the end of 2010 unless Congress opts to retain some or all of them, including the increased credit amount for those with three or more dependents and the "marriage penalty relief" built into the phaseout amounts.

Due to the complexity of the earned income credit rules, the IRS will compute the earned income credit for you if you ask. First, make sure you're eligible for the credit. Then, simply put "EIC" on the dotted line where the credit amount would be entered. Complete all other parts of the return, but omit the lines that relate to your total payments, overpayment, refund, or amount owed (these can be completed only after the IRS figures your EIC). If you have a qualifying child, also complete Form EIC and attach it to the return.

Unearned Income Limit Increased

The earned income credit cannot be claimed if you have unearned income—from interest, dividends, and other investments—that exceeds a set amount. For 2010, the unearned income limit is $3,100 (the same as in 2009). This limit can be adjusted annually for inflation, but if inflation remains low there may be little or no adjustment for 2011.

Advanced Earned Income Credit

For 2010, the credit can be received on an advanced basis by individuals with at least one qualifying child; there is no advanced payment for someone with no qualifying child. The employer must increase take-home pay to account for the advanced payment of the credit. For 2010, the advanced payment can be as much as $1,830. The advanced earned income credit has been repealed starting in 2011. Congress determined that it had been underutilized and that eliminating it would result in additional revenue to fund other tax breaks.

Child Tax Credit

The tax law provides taxpayers with a credit simply for having a child. You don't have to show that you spent a particular amount of money or anything else other than the fact that you have a qualifying child (a child under age 17 who can be claimed as your dependent) or children. The credit amount is $1,000 per

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eligible child (the same as it was in 2009). There is no limit on the number of children for whom this credit can be claimed.

Taxpayers with income above a threshold amount may not claim the credit. The credit begins to phase out for singles with AGI of $75,000 and for married couples filing jointly of $110,000. This AGI threshold has not changed from 2009 and will not be adjusted for inflation in the future.

Refundable Child Tax Credit

At least a portion of the child tax credit may be refundable—paid to you in excess of your tax liability. The refundable amount is 15 percent of earned income from wages or self-employment in excess of a set amount. For 2010, this set amount is $3,000 (the same as it was in 2009).

PLANNING

The current level of the child tax credit is due to sunset at the end of 2010, meaning the credit will be only $500 per eligible child in 2011 unless Congress extends the current break.

Adoption Credit

The tax law rewards by means of a tax credit a parent or parents who adopt a child. Alternatively, a parent may be eligible for an exclusion from income if his or her employer pays such expenses under a company adoption plan. These tax breaks (the credit and the exclusion) are designed to offset to some degree the high cost of adoption, which ranges up to $2,500 for public agency adoptions and can cost $40,000 or more for private agency fees.

All of the qualified costs of adoption can be taken off your tax bill as a credit, up to a set amount. The set amount of the adoption credit increases in 2010 to $13,170 (up from $12,150 in 2009). The credit in 2010 and 2011 is fully refundable, which means you can receive this amount even if it is more than the taxes you owe for the year.

If your employer pays for or reimburses adoption costs under a company's adoption assistance plan in 2010, you can exclude from income up to $13,170. But you can't take a tax credit for the same amount.

With respect to a special-needs child, the credit or exclusion can be claimed without regard to actual expenses; you get it just for making the adoption.

Income Limits

The full credit and exclusion may be claimed only by taxpayers with modified AGI up to $182,520 in 2010 (up from $182,180 in 2009). The credit phases out so that no credit can be claimed once modified AGI exceeds $222,520 in 2010 (up from $222,180 in 2009). The same MAGI limit applies to both singles and joint filers.

PLANNING

When claiming the adoption credit on Form 8839, you cannot file your return electronically; you *must* attach to your paper return:

- For U.S. adoptions, attach a copy of the adoption order or decree.
- For adoptions finalized abroad, include the child's Hague Adoption Certificate, an IH-3 visa, or a foreign adoption decree translated into English. If the child's country of origin is not a party to the Hague Convention, then attach a copy of the translated decree or an IR-2 or IR-3 visa.
- If you adopt a special needs child, also attach the state determination certificate so you can claim the full $13,170, regardless of the adoption costs you paid.

The adoption credit can be indexed for inflation in 2011. Higher credit limits and refundability are set to end on December 31, 2011, unless Congress extends the current rules.

Child and Dependent Care Credit

You may be able to claim a tax credit for costs you incur to care for your child under age 13 or a disabled dependent or spouse of any age so you can work (or attend school). The basic rules for this credit have not changed from last year. The maximum amount of qualified expenses you can take into account in figuring the credit is $3,000 for one qualifying dependent ($6,000 for two or more qualifying dependents). The credit rate depends on your AGI. For those with AGI over $43,000, the credit rate is 20 percent, so your top credit amount is $600 for one dependent and $1,200 for two or more dependents.

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There have been proposals in Congress to increase the amount of this credit, so watch for changes. However, if Congress takes no action, then the amount of

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eligible expenses taken into account for purposes of the credit, along with other favorable rules, will expire at the end of 2010. For example, instead of $3,000 of expenses taken into account for one dependent, only $2,400 could be allowed in 2011, reducing the minimum credit from $600 ($3,000 × 20 percent) to $480 ($2,400 × 20 percent).

Kiddie Tax

The government was concerned that families were putting investments in a child's name so that income received by the child would be taxed at rates lower than those if the parent had kept the investments and received the income. Congress created a so-called kiddie tax on unearned income over a set amount. It is not a separate tax. Rather, the child is taxed on unearned income over a set amount at the parent's highest marginal tax rate.

Example

A child subject to the kiddie tax has $3,000 of investment income above the threshold. The child is in the 10 percent bracket; the parents are in the 28 percent bracket. Under the kiddie tax, the child pays $840 on this income (28 percent of $3,000).

Who Is Subject to the Kiddie Tax?

For 2010, a "child" for purposes of the kiddie tax means a child who is age 18 or under at the end of the year if he or she does not have earned income exceeding half the child's support for the year. It also includes a child who is 19 through 23 as of December 31 if the child is a full-time student during the year and does not have earned income exceeding half of his or her support for the year. The definition of a child for kiddie tax purposes has *not* changed from 2009.

A child who is born on January 1 is treated as having his or her birthday on December 31 of the previous year. Thus, a girl born on January 1, 1987, who has her 24th birthday on January 1, 2011, is treated as being born on December 31, 1986, so that she is considered to be 23 years old in 2010.

If a child otherwise subject to the kiddie tax because of age and income is orphaned, then the kiddie tax does not apply. Also, it does not apply if the child is married and files a joint return with his or her spouse.

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Threshold Amounts

The kiddie tax applies only if the child has unearned income above a threshold amount. For 2010, the threshold is $1,900, which is unchanged from 2009. Unearned income includes interest on bank savings accounts, stock dividends, capital gain distributions from mutual funds, and capital gains from the sale of property.

While the 2010 threshold amount for the kiddie tax is $1,900, the first $950 of unearned income is tax free to the child and the next $950 is taxed to the child at a rate of 10 percent. Only unearned income over $1,900 is taxed to the child at the parent's rate.

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If a child has unearned income over $950 for 2010, a tax return must be filed for the child; the parent usually is the person to do this and signs the return as follows: "By [your signature], parent [or guardian] for minor child."

However, a parent can elect to include the child's unearned income on the parent's own return and avoid the need to file a separate return for the child. In order to make this election and report the child's income on the parent's return, all of the following conditions must be met:

- The child's only income for the year is from interest and dividends (including capital gain distributions from mutual funds and Alaska Permanent Fund dividends).
- This unearned income totals more than $950 but not more than $9,500.
- No estimated taxes were paid on behalf of the child for the year and there was no tax overpayment from the previous year applied to estimated taxes for the year.
- The child is not subject to backup withholding.

Just because you are eligible to report your child's unearned income on your return does not mean it's a good idea to do so. Adding the child's unearned income to your own will increase your adjusted gross income by the amount of the child's unearned income, which can limit or prevent you from qualifying for many tax breaks. The only two instances in which it may be helpful are:

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1. When you want to boost your investment interest deduction by adding your child's investment income to your own so you can claim a larger deduction for investment interest.
2. When you want to increase AGI/MAGI so you can claim a larger charitable contribution deduction.

A child's earnings from a job or self-employment are not subject to the kiddie tax. Parents who have businesses may employ their children, enabling the family to reap several tax benefits:

- Wages for a child up to $5,700 are tax free in 2010.
- The child can contribute his or her earnings (up to $5,000) to an IRA or Roth IRA.
- The parent can deduct wages paid to the child as a business expense.
- If the parent is self-employed and the child is under the age of 18, then wages paid by the parent are exempt from payroll taxes (FICA [Federal Insurance Contributions Act] and FUTA [Federal Unemployment Tax Act]).

Additional Medicare Tax

Starting in 2013, there is a new 3.8 percent additional Medicare tax on investment income of individuals with MAGI of more than $200,000, or joint filers with MAGI of more than $250,000. Currently, it is not clear whether this additional Medicare tax will affect children subject to the kiddie tax if their parents' MAGI tops the threshold for the additional Medicare tax.

PLANNING

Watch for developments concerning the application of the additional Medicare tax to the kiddie tax.

Tax on Household Employees

If you engage workers in your home who are not in their own businesses or are not employees of a company, such as an agency, then you may be obligated to pay employment taxes for your household employees. Employment tax on household employees is referred to as the "nanny tax." The nanny tax imposed

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on wages paid to household employees isn't limited to nannies. It can apply to housekeepers, au pairs, cooks, drivers, gardeners, and anyone else who works for you or your family full-time or part-time. The nanny tax comprises Social Security and Medicare (FICA) taxes and federal unemployment (FUTA) tax.

FICA is required for a household employee only if cash wages exceed a threshold amount. For 2010, the threshold amount is $1,700, the same as it was in 2009. Once wages exceed the threshold, then *all* wages for the year are subject to FICA; there is no exemption for the first $1,700. FICA taxes are explained earlier in this chapter.

FUTA taxes apply if you pay cash wages of $1,000 or more during any calendar quarter in 2009 or 2010. The FUTA rate is 6.2 percent of the first $7,000 of cash wages; there is a credit of 5.4 percent, so the actual rate is 0.8 percent (the top FUTA payment per worker usually is $56). However, rates for residents in some states may be higher in 2010 and 2011 because state unemployment funds have not repaid funds borrowed from the federal government; check with your state unemployment office (find links to your state's tax department at www.business.gov/manage/taxes/state.html).

PLANNING

Certain workers are exempt, meaning you don't owe FICA on their wages regardless of amount. These include your spouse, your parent, your child under age 21, or any individual under age 18 if providing household services is not his or her principle occupation.

For FUTA, no tax is due on wages paid to a spouse, parents, or your child under age 21.

If you are liable for any nanny tax, you'll need an employer identification number (EIN); you can't use your Social Security number for tax-reporting purposes. You can obtain one easily (at no cost) from the IRS at www.irs.gov/businesses/small/article/0,,id=102767,00.html.

You also may owe state unemployment insurance and need to pay workers' compensation for household employees. Contact your state labor department for details—find a link to your state's department through the American Federation of State, County, and Municipal Employees (AFSCME) at www.afscme.org/publications/11820.cfm.