



When Is A Child Not A Dependent? New Rules Define Qualifying Dependents

Generally, when determining how to fill out the Form 1040 for tax filing, the old rule required the following to be true: 1) The taxpayer provided over half of the individual's support, and 2) The individual was a relative or someone whose principal abode was the taxpayer's and was a member of the taxpayer's household.

The Working Families Tax Relief Act of 2004 created a new standardized definition of dependent. An individual now would be considered a dependent if they fall under one of the following: 1) Qualified Child, or 2) Qualified Relative.

These new descriptions are used to provide benefits under health plans, Health FSAs, HRAs, and dependent care plans. So, what are the new rules, and how do they affect FSA participants? Let's start with the new definitions.

New definitions

To be recognized as a qualifying child, a person must meet four tests:

1. **Relationship.** The taxpayer's child or stepchild (whether by blood or adoption), foster child, sibling or step sibling, or a descendant of one of these.
2. **Residence.** Has the same principal residence as the taxpayer for more than half the tax year. Exceptions apply, in certain cases, for children of divorced or separated parents, and other special instances.
3. **Age.** Must be under the age of 19 at the end of the tax year, or under the age of 24 if a full-time student for at least five months of the year, or be permanently and totally disabled at any time during the tax year.
4. **Support.** Did not provide more than one-half of his/her own support for the tax year.

Additional requirements:

- Be a U.S. citizen or national, or a resident of the U.S., Canada, or Mexico. There is an exception for certain adopted children.
- Marital status. If married, did not file a joint return for that year, unless the return is filed only as a claim for refund and no tax liability would exist for either spouse if they had filed separate returns.

This new definition is different from the previous in a couple of ways. First, the qualifying child must have the same residence as the taxpayer; and second, the taxpayer no longer needs to provide over half of the child's support. The support test states that the child did not provide over half of their own support.

Example

Last year, in 2004, Jack lived in a home with his four-year-old son. Because of work-related travel, Jack moved to another city and left his son in the care of his son's grandmother. In 2004, Jack could still claim his son as a dependent because of their relationship to each other and because Jack provided over half of his son's total support.

In 2005 it's a different story. Jack can no longer claim his son as a dependent because the two do not share the same principal residence.

If a person does not meet the "qualified child" tests, then move on to the "qualified relative" tests to see if the individual could be considered a dependent based on these tests.

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To be recognized as a qualifying relative, a person must meet four tests:

1. Relationship. An individual who bears a relationship to the taxpayer as described under Code Section 152(d)(2), including someone who has the same principal abode as the taxpayer for the taxable year and is a member of the taxpayer's household.
2. Gross Income. Has gross income that is less than \$3,200 for 2005 tax year. (Gross income limit test does not apply to health plans so you may omit this definition when looking at a health plan, Health FSA, or HRA.)
3. Support. For whom the taxpayer provides over one-half of the individual's support for that calendar year, and
4. Qualifying Child. Is not an otherwise "qualifying child" of the taxpayer or of any other taxpayer for any portion of the year.

What does this mean for flex participants?

Generally, pre-tax benefits only may be afforded to the employee, their spouses and dependents. Benefits coverage for all others is to be paid with taxed dollars. Here's what to tell participants:

- A qualifying child must live with the participant.
- The taxpayer need not maintain the home that they and their dependents live in.
- The taxpayer need not provide more than one half of the qualifying child's support.
- Domestic partners must fall under the "qualifying relative" definition.

What happens if benefits for a non-qualified child or relative are provided on a pre-tax basis? It might mean that any benefits paid from the plan could be taxable to the participant.

Providing tax-free dependent care benefits

This is where it gets a little tricky. The new definition of "qualifying relative" may prevent employees from receiving tax-free benefits for daycare.

Elder care. The new Gross Income rule in the definition of a "qualifying relative" may have more than a few of the Baby Boomers without the Dependent Care Expense credit. An otherwise qualifying relative, making over the exemption amount of \$3,200 for 2005, is automatically disqualified as a "qualifying relative." Parents who are physically or mentally incapable of self-care may not qualify for the daycare credit any more – if they earn more than \$3,200 in 2005.

Childcare. On the other hand, the new definition may help others. Take for example a mom and dad who live with dad's parents. Under the old rules, there was a "maintaining a home" rule. It meant that mom and dad had to pay more than half the cost of keeping up the home. Now, if their child lives in the same principal residence and passes the relationship and support rules, the parents may receive tax-free benefits for daycare.

Let's say that Joe and Jane live with Joe's parents. Joe and Jane have two children that live with them and they pay more than half of their children's support. If they meet all the other requirements, Joe and Jane may take advantage of the dependent care expense credit.

Employee certification

Every employer or plan service provider cannot possibly know if dependents listed by participants pass all these tests. The IRS has said that a written certification from the participant will suffice as an indication to authenticity of the facts and circumstances. ■

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