

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Parts 1 and 602**

[REG-139059-02]

RIN 1545-BB86

Expenses for Household and Dependent Care Services Necessary for Gainful Employment**AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the credit for expenses for household and dependent care services necessary for gainful employment. The proposed regulations reflect statutory amendments under the Deficit Reduction Act of 1984, the Omnibus Budget Reconciliation Act of 1987, the Family Support Act of 1988, the Small Business Job Protection Act of 1996, the Economic Growth and Tax Relief Reconciliation Act of 2001, the Job Creation and Worker Assistance Act of 2002, and the Working Families Tax Relief Act of 2004. The proposed regulations affect taxpayers who claim the credit for household and dependent care services and dependent care providers.

DATES: Written or electronic comments must be received by August 22, 2006.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-139059-02), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-139059-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at <http://www.irs.gov/regs> or via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS and REG-139059-02).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Sara Shepherd (202) 622-4960; Concerning submissions of comments or a request for a public hearing, Richard Hurst, richard.a.hurst@irs.counsel.treas.gov, or (202) 622-7180 (not toll free numbers).

SUPPLEMENTARY INFORMATION:**Background**

This document contains proposed amendments to the Income Tax

Regulations, 26 CFR part 1, relating to the credit for household and dependent care services necessary for gainful employment (the credit) under section 21 of the Internal Revenue Code (Code).

The credit was originally enacted as section 44A. Final regulations under section 44A were published as "1.44A-1 through 1.44-4 on August 27, 1979 (section 44A regulations). Section 44A was amended and renumbered section 21 by sections 423 and 471, respectively, of the Deficit Reduction Act of 1984 (Pub. L. 98-369, 98 Stat. 494). Section 21 was amended by section 10101 of the Omnibus Budget Reconciliation Act of 1987 (Pub. L. 100-203, 101 Stat. 1330), section 703 of the Family Support Act of 1988 (Pub. L. 100-485, 102 Stat. 2343), section 1615 of the Small Business Job Protection Act of 1996 (Pub. L. 104-188, 110 Stat. 1755), section 204 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16, 115 Stat. 38), section 418 of the Job Creation and Worker Assistance Act of 2002 (Pub. L. 107-147, 116 Stat. 21), and sections 203 and 207 of the Working Families Tax Relief Act of 2004 (Pub. L. 108-311, 118 Stat. 1166), as well as other legislation that enacted clerical and conforming changes.

Section 21 allows a nonrefundable credit for a percentage of expenses for household and dependent care services necessary for gainful employment. For taxable years beginning after December 31, 2004, the credit is available to a taxpayer if there are one or more qualifying individuals with respect to that taxpayer. For those years, a *qualifying individual* is defined in section 21(b)(1) as the taxpayer's dependent (as defined in section 152(a)(1)) who has not attained age 13, the taxpayer's dependent who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year, or the taxpayer's spouse who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year.

For taxable years beginning before January 1, 2005, the credit is available to taxpayers who maintained households that include one or more qualifying individuals. For those years, a *qualifying individual* is defined in section 21(b)(1) as the taxpayer's dependent (as defined in section 151(c) as then in effect) under age 13, the taxpayer's dependent who is physically or mentally incapable of self-care, or the taxpayer's spouse who is physically or mentally incapable of self-care.

Under section 21(a), the amount of the credit is equal to the applicable percentage of employment-related expenses paid by the taxpayer during the taxable year. The applicable percentage ranges from 20 percent to 35 percent depending on the taxpayer's adjusted gross income. Section 21(c) limits the amount of employment-related expenses that may be taken into account in determining the credit in any taxable year to \$2,400 if there is one qualifying individual and \$4,800 if there are two or more qualifying individuals. These amounts are increased, respectively, to \$3,000 and \$6,000 in taxable years beginning after December 31, 2002, and before January 1, 2011.

Section 21(d) further limits the amount of employment-related expenses that may be taken into account in determining the credit to the lesser of the earned income of the taxpayer or the taxpayer's spouse (if any). The earned income for each month in which a taxpayer's spouse is a full-time student or incapable of self-care is deemed to be \$200 (for one qualifying individual) or \$400 (for two or more qualifying individuals), increased to \$250 and \$500 for taxable years beginning after December 31, 2002, and before January 1, 2011.

Section 21(b)(2) defines employment-related expenses as amounts paid for household services and expenses for the care of a qualifying individual that enable the taxpayer to be gainfully employed for any period for which there are one or more qualifying individuals with respect to the taxpayer.

Explanation of Provisions

1. Overview

The proposed regulations incorporate many of the rules in the section 44A regulations, but are renumbered, restructured, and revised to improve clarity. The proposed regulations reflect statutory amendments enacted since publication of the section 44A regulations. Accordingly, the proposed regulations include a change in the definition of a qualifying individual, a reduction in the maximum age of a qualifying child from under 15 to under 13, and an increase in the maximum amount of creditable expenses and the monthly amount of deemed earned income of a spouse who is a full-time student or incapable of self-care for taxable years beginning after December 31, 2002, and before January 1, 2011. The proposed regulations provide additional rules that address significant issues that have arisen administratively since publication of the section 44A regulations and expand the number of

examples. The substantive revisions, additions, and significant clarifications to the section 44A regulations are described below.

2. Taxable Year of Credit

Section 21 refers interchangeably to expenses "paid" by the taxpayer and expenses "incurred" by the taxpayer. Section 1.44A-1(a)(3) reconciles this use of various tax accounting terms by providing that, regardless of the taxpayer's method of accounting, the credit is allowable only for expenses both "paid" during the taxable year and "incurred" during the taxable year or an earlier taxable year. The proposed regulations restate this rule in plain language and provide that the credit is allowable only in the taxable year in which the services are provided or the taxable year in which the expenses are paid, whichever is later, regardless of the taxpayer's method of accounting.

3. Special Rule for Children of Separated or Divorced Parents

Section 21(e)(5) provides that, in the case of a child of divorced or separated parents, only the custodial parent may claim the credit, regardless of whether the noncustodial parent may claim the dependency exemption under section 152(e). The proposed regulations define custodial parent consistently with section 152(e)(3)(A) as the parent with whom the child shares the same principal place of abode for the greater portion of the calendar year.

4. Employment-Related Expenses

Under section 21(b)(2)(A), expenses are employment-related only if (1) the expenses are primarily for household services or for the care of a qualifying individual, and (2) the taxpayer's purpose in obtaining the services is to enable the taxpayer to be gainfully employed.

a. Nature of the Services Provided

(1) Expenses for Nursery School and Kindergarten

The section 44A regulations provide that expenses are primarily for the care of a qualifying individual if the primary nature of the services is to ensure the qualifying individual's well-being and protection. Amounts paid for food, lodging, clothing, or education are not for the care of a qualifying individual. However, if these services are incidental to and inseparably a part of the care of a qualifying individual, the entire amount of the expense is deemed to be for care.

Section 1.44A-1(c)(3)(i).

Section 1.44A-1(c)(3)(i) provides an example that concludes that the full

amount paid to a nursery school is for the care of a qualifying child even though the school furnishes lunch and educational services. Although intended to illustrate the incidental services rule, the example assumes that expenses for nursery school are for care. Section 1.44A-1(c)(3)(i) also provides that expenses for education in the first or higher grade are not for the care of a qualifying individual. The section 44A regulations do not address expenses for kindergarten.

The proposed regulations provide the rule that the expenses of pre-school or similar programs below the kindergarten level are for care and may be employment-related expenses, if otherwise qualified, although education may be a significant part of these programs. The proposed regulations clarify the existing rule that expenses for programs at the level of kindergarten and above, however, are primarily for education and, therefore, are not employment-related expenses.

(2) Specialty Day Camps

Section 21(b)(2)(A) provides that expenses for overnight camps are not employment-related expenses. Expenses for day camps may be employment-related expenses, if otherwise qualified. The IRS has received many inquiries about whether the cost of a day camp that specializes in a particular activity, such as soccer or computers, may be an employment-related expense. To provide certainty for taxpayers and enhance administrability, the proposed regulations provide that the full amount paid for a day camp or similar program may be for the care of a qualifying individual although the camp specializes in a particular activity.

(3) Transportation Expenses

Section 1.44A-1(c)(3)(i) provides that expenses for transportation of a qualifying individual between the taxpayer's household and a place outside the taxpayer's household where care is provided are not for care. The proposed regulations provide that the cost of transportation (such as transportation to a day camp or to an after-school program not on school premises) furnished by a dependent care provider may be an employment-related expense if all other applicable requirements are satisfied.

(4) Other Expenses For Care

Section 1.44A-1(c)(1)(i) provides that employment taxes that a taxpayer pays are employment-related expenses if the related wages are employment-related expenses. Rev. Rul. 76-288 (1976-2 C.B. 83) holds that additional costs for a care

provider's room and board are employment-related expenses. The proposed regulations incorporate these rules. Additionally, the proposed regulations clarify that indirect expenses such as application and agency fees may be employment-related expenses if the taxpayer is required to pay the expenses to obtain the care.

b. Expenses To Enable the Taxpayer To Be Gainfully Employed

Under section 21(b)(2)(A), an expense may be an employment-related expense only if its purpose is to enable the taxpayer to be gainfully employed. Section 1.44A-1(c)(1)(i) provides that an expense must be incurred while the taxpayer is gainfully employed or is in active search of gainful employment. An expense is not employment-related, however, merely because the services are provided while the taxpayer is employed. Rather, the purpose of the expense must be to enable the taxpayer to be gainfully employed.

Rev. Rul. 76-278 (1976-2 C.B. 84) holds that expenses for dependent care services during a taxpayer's 6-month absence from work due to illness do not qualify as employment-related expenses although the taxpayer was gainfully employed during that period. The expenses were not for the purpose of enabling the taxpayer to be gainfully employed because the expenses did not contribute to the taxpayer's ability to be gainfully employed during the absence.

Section 1.44A-1(c)(1)(ii) provides that a taxpayer must allocate on a daily basis expenses that relate to a period during only part of which the taxpayer is gainfully employed or in search of gainful employment. The proposed regulations clarify how this rule applies to temporary absences from work and part-time employment. The proposed regulations provide that, in general, dependent care expenses for a period in which the taxpayer is absent from work (whether paid or unpaid) are not employment-related expenses. However, for administrative convenience, short, temporary absences from work, such as for minor illness or vacation, are disregarded for taxpayers who must pay for dependent care expenses on a weekly or longer basis. Whether an absence is short and temporary depends on the facts and circumstances. The IRS and the Treasury Department request comments on appropriate periods to constitute temporary absence safe harbors.

The proposed regulations provide that, in general, taxpayers who work part-time must allocate expenses between days worked and days not worked. However, taxpayers who work

part-time but are required to pay for dependent care expenses on a weekly or longer basis are not required to allocate expenses between days worked and days not worked.

5. Limitations on Amount Creditable

a. Application of Dollar Limitation to Two or More Qualifying Individuals

Under section 21(c), the amount of employment-related expenses that a taxpayer may take into account in any taxable year is \$2,400 for one qualifying individual and \$4,800 for more than one qualifying individual (increased to \$3,000 and \$6,000 for taxable years beginning after December 31, 2002, and before January 1, 2011). The proposed regulations clarify that a taxpayer may apply the limitation for two or more qualifying individuals in unequal proportions. Thus, if in taxable year 2004 a taxpayer pays \$4,000 of employment-related expenses for the care of one child and \$2,000 for another child, the taxpayer may take into account the full \$6,000.

b. Earned Income Limitation

Section 21(d) provides that the amount of employment-related expenses that may be taken into account during any taxable year cannot exceed the taxpayer's earned income or, if married, the earned income of the taxpayer's spouse (whichever is less). A spouse who is a full-time student or is incapable of self-care is deemed to have earned income for each month of not less than \$200 if there is one qualifying individual or \$400 if there are two or more qualifying individuals with respect to the taxpayer for the taxable year. These amounts are increased, respectively, to \$250 and \$500 for taxable years beginning after December 31, 2002, and before January 1, 2011. Section 1.44A-2(b)(2) provides a definition of *earned income* that is similar to the definition under section 32 (relating to the earned income credit) and the regulations thereunder. Since this regulation was issued, the section 32 definition has changed several times. For ease of administration, the proposed regulations simplify the definition of earned income by cross-referencing the definition under section 32.

Section 1.44A-2(b)(3)(ii) defines a *full-time student* as a student pursuing a full-time course of study, which cannot be exclusively at night. The proposed regulations delete the night school restriction.

6. Cost of Maintaining a Household

For taxable years beginning before January 1, 2005, section 21(a)(1)

provides that the credit is available to a taxpayer who maintains a household that includes one or more qualifying individuals. For those years, section 21(e)(1) provides that a taxpayer is treated as maintaining a household for any period only if over half the cost of maintaining the household is furnished by the taxpayer or by the taxpayer and spouse (if any). Section 1.44A-1(d)(3) defines *cost of maintaining a household* substantially identically to the definition in § 1.2-2(d) (relating to the head of household filing status). For simplicity, the proposed regulations cross-reference to the definition of *cost of maintaining a household* in § 1.2-2(d) without regard to the last sentence of that paragraph. In lieu of that sentence, the proposed regulations provide that, for purposes of section 21, the cost of maintaining a household does not include the value of services performed in the household by the taxpayer or a qualifying individual, or expenses paid or reimbursed by another person.

7. Principal Place of Abode

For taxable years beginning after December 31, 2004, the principal place of abode test statutorily replaces the maintaining a household test. Under section 21(b)(1), a qualifying individual must have the same principal place of abode as the taxpayer for more than one-half of the taxable year. For simplicity, the proposed regulations provide that *principal place of abode* has the same meaning as in section 152 and the regulations thereunder.

8. Definition of Marital Status

Under section 21(e)(2), the credit is allowed to married taxpayers only if they file a joint return. Section 21(e)(3) provides that taxpayers who are legally separated under a decree of divorce or separate maintenance are not married. The proposed regulations, in general, adopt the rules of section 7703 and the regulations thereunder to determine whether taxpayers are married for purposes of section 21. However, to maintain continued consistency with section 21(e)(3), the proposed regulations provide, in addition, that taxpayers who are legally separated under a decree of divorce or separate maintenance are not married.

9. Payments to Related Individuals

Section 21(e)(6) provides that payments to a taxpayer's dependent or child under age 19 do not qualify for the credit. Payments to a relative may qualify for the credit if the relative is not a dependent. The proposed regulations clarify that payments to either the

taxpayer's spouse or to a parent of the taxpayer's child who is not the taxpayer's spouse do not qualify for the credit. This rule is consistent with the requirement that a married couple must file a joint return to qualify for the credit, and with the principle that the tax treatment of a payment with respect to a child may be affected by an individual's underlying legal obligation to the child. See section 21(e)(2); compare section 677(b).

10. Proposed Effective Date

The regulations are proposed to apply to taxable years ending after the date the regulations are published as final regulations in the **Federal Register**. However, taxpayers may apply the proposed regulations in taxable years for which the period of limitation on credit or refund under section 6511 has not expired as of May 24, 2006.

11. Effect on Other Documents

When finalized, the regulations would obsolete Rev. Rul. 76-278 (1976-2 C.B. 84) and Rev. Rul. 76-288 (1976-2 C.B. 83).

Special Analyses

This notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Warren Joseph of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are proposed to be amended as follows:

PART I—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.21-1 also issued under 26 U.S.C. 21(f).
Section 1.21-2 also issued under 26 U.S.C. 21(f).
Section 1.21-3 also issued under 26 U.S.C. 21(f).
Section 1.21-4 also issued under 26 U.S.C. 21(f) * * *

§ 1.21-1 [Redesignated]

Par. 2. Section 1.21-1 is redesignated 1.15-1.

Par. 3. Sections 1.21-1, 1.21-2, 1.21-3, and 1.21-4 are added to read as follows:

§ 1.21-1 Expenses for household and dependent care services necessary for gainful employment.

(a) *In general.* (1) Section 21 allows a credit to a taxpayer against the tax imposed by chapter 1 for employment-related expenses for household services and care (as defined in paragraph (d) of this section) of a qualifying individual (as defined in paragraph (b) of this section). The purpose of the expenses must be to enable the taxpayer to be gainfully employed (as defined in paragraph (c) of this section). For taxable years beginning after December 31, 2004, a qualifying individual must have the same principal place of abode (as defined in paragraph (g) of this section) as the taxpayer for more than one-half of the taxable year. For taxable years beginning before January 1, 2005, the taxpayer must maintain a household (as defined in paragraph (h) of this section) that includes one or more qualifying individuals.

(2) The amount of the credit is equal to the applicable percentage of the employment-related expenses that may be taken into account by the taxpayer during the taxable year (but subject to the limits prescribed in § 1.21-2). *Applicable percentage* means 35 percent reduced by 1 percentage point for each \$2,000 (or fraction thereof) by which the taxpayer's adjusted gross income for the taxable year exceeds \$15,000, but not less than 20 percent. For example, if a taxpayer's adjusted gross income is \$31,850, the applicable percentage is 26 percent.

(3) Expenses may be taken into account, regardless of the taxpayer's method of accounting, only in the taxable year the services are provided or the taxable year the expenses are paid, whichever is later.

(4) The requirements of section 21 and §§ 1.21-1 through 1.21-4 are applied at the time the services are provided, regardless of when the expenses are paid.

(b) *Qualifying individual*—(1) *In general.* For taxable years beginning after December 31, 2004, a qualifying individual is—

(i) The taxpayer's dependent (who is a qualifying child within the meaning of section 152) who has not attained age 13;

(ii) The taxpayer's dependent who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year; or

(iii) The taxpayer's spouse who is physically or mentally incapable of self-care and who has the same principal abode as the taxpayer for more than one-half of the taxable year.

(2) *Taxable years beginning before January 1, 2005.* For taxable years beginning before January 1, 2005, a qualifying individual is—

(i) The taxpayer's dependent for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(c) and who is under age 13;

(ii) The taxpayer's dependent who is physically or mentally incapable of self-care; or

(iii) The taxpayer's spouse who is physically or mentally incapable of self-care.

(3) *Qualification on a daily basis.* The status of an individual as a qualifying individual is determined on a daily basis. An individual is not a qualifying individual on the day the status terminates.

(4) *Physical or mental incapacity.* An individual is physically or mentally incapable of self-care if, as a result of a physical or mental defect, the

individual is incapable of caring for the individual's hygiene or nutritional needs, or requires full-time attention of another person for the individual's own safety or the safety of others. The inability of an individual to engage in any substantial gainful activity or to perform the normal household functions of a homemaker or care for minor children by reason of a physical or mental condition does not of itself establish that the individual is physically or mentally incapable of self-care.

(5) *Special test for divorced or separated parents*—(i) *Scope*. This paragraph (b)(5) applies to a child (as defined in section 152(f)(1) for taxable years beginning after December 31, 2004, and in section 151(c)(3) for taxable years beginning before January 1, 2005) who—

(A) Is under age 13 or is physically or mentally incapable of self-care;

(B) Receives over one-half of his or her support during the calendar year from one or both parents who are divorced or legally separated under a decree of divorce or separate maintenance or who are separated under a written separation agreement; and

(C) Is in the custody of one or both parents for more than one-half of the calendar year.

(ii) *Custodial parent allowed the credit*. A child to whom this paragraph (b)(5) applies is the qualifying individual of only one parent in any taxable year and is the qualifying child of the custodial parent even if the noncustodial parent may claim the dependency exemption for that child for that taxable year. See section 152(e). The custodial parent is the parent with whom a child shared the same principal place of abode for the greater portion of the calendar year. See section 152(e)(3)(A).

(c) *Gainful employment*—(1) *In general*. Expenses are employment-related expenses only if they are for the purpose of enabling the taxpayer to be gainfully employed. The expenses must be for the care of a qualifying individual or household services provided during periods in which the taxpayer is gainfully employed or is in active search of gainful employment. Employment may consist of service within or outside the taxpayer's home and includes self-employment. An expense is not employment-related merely because it is paid or incurred while the taxpayer is gainfully employed. The purpose of the expense must be to enable the taxpayer to be gainfully employed. Whether the purpose of an expense is to enable the taxpayer to be gainfully employed

depends on the facts and circumstances of the particular case. Work as a volunteer or for a nominal consideration is not gainful employment.

(2) *Determination of period of employment on a daily basis*—(i) *In general*. Expenses paid for a period during only part of which the taxpayer is gainfully employed or in active search of gainful employment must be allocated on a daily basis.

(ii) *Exception for short temporary absences*. A taxpayer who is gainfully employed and who pays for dependent care expenses on a weekly, monthly, or annual basis is not required to allocate expenses during short, temporary absences from work, such as for vacation or minor illness. Whether an absence is a short, temporary absence is determined based on all the facts and circumstances.

(iii) *Part-time employment*. A taxpayer who is employed part-time generally must allocate expenses for dependent care between days worked and days not worked. However, if a taxpayer employed part time is required to pay for dependent care on a periodic basis (such as weekly or monthly) that includes both days worked and days not worked, the taxpayer is not required to allocate the expenses. A day on which the taxpayer works at least 1 hour is a day of work.

(3) *Examples*. The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. B, the custodial parent of two qualifying children, hires a housekeeper for a monthly salary to care for the children while B is gainfully employed. B becomes ill and as a result is absent from work for 4 months. B continues to pay the housekeeper to care for the children while B is absent from work. During this 4-month period, B performs no employment services, but receives payments under her employer's wage continuation plan. Although B may be considered to be gainfully employed during her absence from work, the absence is not a short, temporary absence within the meaning of paragraph (c)(2)(ii) of this section, and her payments for household and dependent care services during the period of illness are not for the purpose of enabling her to be gainfully employed. B's expenses are not employment-related expenses, and she may not take the expenses into account under section 21.

Example 2. C works 5 days per week and his child attends a dependent care center (that complies with all state and local requirements) to enable C to be gainfully employed. The dependent care center requires payment for periods of no less than 1 week. C takes 2 days off from work as vacation days. Under paragraph (c)(2)(ii) of this section, C is absent from work on a short, temporary basis, and is not required to allocate expenses between days working and days not working. The entire fee for that

week may be an employment-related expense under section 21.

Example 3. D works 3 days per week and her child attends a dependent care center (that complies with all state and local requirements) to enable her to be gainfully employed. The dependent care center allows payment for any 3 days per week for \$150 or 5 days per week for \$250. D enrolls her child for 5 days per week. Under paragraph (c)(2)(iii) of this section, D must allocate her expenses for dependent care between days worked and days not worked. Three-fifths of the \$250, or \$150 per week, may be an employment-related expense under section 21.

Example 4. The facts are the same as in *Example 3*, except that the dependent care center does not offer a 3-day option. The entire \$250 weekly fee may be an employment-related expense under section 21.

(d) *Care of qualifying individual and household services*—(1) *In general*. To qualify for the dependent care credit, expenses must be for the care of a qualifying individual. Expenses are for the care of a qualifying individual if the primary function is to assure the individual's well-being and protection. Not all expenses relating to a qualifying individual are provided for the individual's care. Amounts paid for food, lodging, clothing, or education are not for the care of a qualifying individual. If, however, the care is provided in such a manner that the expenses cover other goods or services that are incidental to and inseparably a part of the care, the full amount is for care.

(2) *Allocation of expenses*. If an expense is partly for household services or for the care of a qualifying individual and partly for other goods or services, a reasonable allocation must be made. Only so much of the expense that is allocable to the household services or care of a qualifying individual is an employment-related expense.

An allocation must be made if a housekeeper or other domestic employee performs household duties and cares for the qualifying children of the taxpayer and also performs other services for the taxpayer. No allocation is required, however, if the expense for the other purpose is minimal or insignificant or if an expense is partly attributable to the care of a qualifying individual and partly to household services.

(3) *Household services*. Expenses for household services may be employment-related expenses if the services are provided in connection with the care of a qualifying individual. The household services must be the performance in and about the taxpayer's home of ordinary and usual services

necessary to the maintenance of the household and attributable to the care of the qualifying individual. Services of a housekeeper are household services within the meaning of this paragraph (d)(3) if part of those services is provided to the qualifying individual. Such services as are provided by chauffeurs, bartenders, or gardeners are not household services.

(4) *Manner of providing care.* The manner of providing the care need not be the least expensive alternative available to the taxpayer. The cost of a paid caregiver may be an expense for the care of a qualifying individual even if another caregiver is available at no cost.

(5) *School or similar program.* Expenses for a child in nursery school, pre-school, or similar programs for children below the level of kindergarten are for the care of a qualifying individual and may be employment-related expenses. Expenses for a child in kindergarten or a higher grade are not for the care of a qualifying individual. However, expenses for before- or after-school care of a child in kindergarten or a higher grade may be for the care of a qualifying individual.

(6) *Overnight camps.* Expenses for overnight camps are not employment-related expenses.

(7) *Day camps.* The cost of a day camp or similar program may be for the care of a qualifying individual and an employment-related expense, without allocation under paragraph (d)(2) of this section, even if the day camp specializes in a particular activity.

(8) *Transportation.* The cost of transportation by a dependent care provider of a qualifying individual to or from a place where care of that qualifying individual is provided may be for the care of the qualifying individual. The cost of transportation not provided by a dependent care provider is not for the care of the qualifying individual.

(9) *Employment taxes.* Taxes under section 3111 (relating to the Federal Insurance Contributions Act) and 3301 (relating to the Federal Unemployment Tax Act) and similar state payroll taxes are employment-related expenses if paid in respect of wages that are employment-related expenses.

(10) *Room and board.* The additional cost of providing room and board for a caregiver over usual household expenditures may be an employment-related expense.

(11) *Indirect expenses.* Expenses that relate to but are not directly for the care of a qualifying individual, such as application fees, agency fees, and deposits, may be for the care of a

qualifying individual and may be employment-related expenses if the taxpayer is required to pay the expenses to obtain the related care. However, forfeited deposits and other payments are not for the care of a qualifying individual if care is not provided.

(12) *Examples.* The provisions of this paragraph (d) are illustrated by the following examples:

Example 1. To be gainfully employed, E sends his 3-year old child to a pre-school. The pre-school provides lunch and snacks. Under paragraph (d)(1) of this section, E is not required to allocate expenses between care and the lunch and snacks because the lunch and snacks are incidental to and inseparably a part of the care. Therefore, E may treat the full amount paid to the pre-school as for the care of his child.

Example 2. F, a member of the armed forces, is ordered to a combat zone. To be able to comply with the orders, F places her 10-year old child in boarding school. The school provides education, meals, and housing to F's child in addition to care. Under paragraph (d)(2) of this section, F must allocate the cost of the boarding school between expenses for care and expenses for education and other services not constituting care. Only the part of the cost of the boarding school that is for the care of F's child is an employment-related expense under section 21.

Example 3. To be gainfully employed, G employs a full-time housekeeper to care for G's two children, aged 9 and 13 years. The housekeeper regularly performs household services of cleaning and cooking and drives G to and from G's place of employment, a trip of 15 minutes each way. Under paragraph (d)(3) of this section, the chauffeur services are not household services. G is not required to allocate a portion of the expense of the housekeeper to the chauffeur services, however, because the chauffeur services are minimal and insignificant. Further, no allocation under paragraph (d)(2) of this section is required to determine the portion of the expenses attributable to the care of the 13-year old child (not a qualifying individual) because the household expenses are in part attributable to the care of the 9-year old child. Accordingly, the entire expense of employing the housekeeper is an employment-related expense. The amount that G may take into account as an employment-related expense under section 21, however, is limited to the amount allowable for one qualifying individual.

Example 4. To be gainfully employed, H sends her 9-year old child to a summer day camp that specializes in computer instruction and activities. Under paragraph (d)(7) of this section, the full cost of the summer day camp may be for care although it specializes in a particular activity, computers.

Example 5. In 2004, J pays a fee to an agency to obtain the services of an au pair to care for J's qualifying children to enable J to be gainfully employed. The au pair begins caring for J's children in 2005. Under paragraph (d)(11) of this section, the fee paid in 2004 may be an employment-related

expense. However, under paragraph (a)(3) of this section, J may not take the expense into account under section 21 until 2005, when the au pair first provides the care.

Example 6. K places a deposit with a pre-school to reserve a place for her child. K sends the child to another pre-school and forfeits the deposit. Under paragraph (d)(11) of this section, the forfeited deposit is not an employment-related expense.

(e) *Services outside the taxpayer's household—(1) In general.* The credit is allowable for expenses for services performed outside the taxpayer's household only if the care is for one or more qualifying individuals who are described in this section at—

(i) Paragraph (b)(1)(i) or (b)(2)(i); or
(ii) Paragraph (b)(2)(ii) or (b)(2)(iii) and regularly spend at least 8 hours each day in the taxpayer's household.

(2) *Dependent care centers—(i) In general.* The credit is allowable for services provided by a dependent care center only if—

(A) The center complies with all applicable laws and regulations, if any, of a state or local government, such as state or local licensing requirements and building and fire code regulations; and
(B) The requirements provided in this paragraph (e) are met.

(ii) *Definition.* The term *dependent care center* means any facility that provides full-time or part-time care for more than six individuals (other than individuals who reside at the facility) on a regular basis during the taxpayer's taxable year, and receives a fee, payment, or grant for providing services for the individuals (regardless of whether the facility is operated for profit). For purposes of the preceding sentence, a facility is presumed to provide full-time or part-time care for six or fewer individuals on a regular basis during the taxpayer's taxable year if the facility has six or fewer individuals (including the taxpayer's qualifying individual) enrolled for full-time or part-time care on the day the qualifying individual is enrolled in the facility (or on the first day of the taxable year the qualifying individual attends the facility if the qualifying individual was enrolled in the facility in the preceding taxable year) unless the Internal Revenue Service demonstrates that the facility provides full-time or part-time care for more than six individuals on a regular basis during the taxpayer's taxable year.

(f) *Reimbursed expenses.*

Employment-related expenses for which the taxpayer is reimbursed (for example, under a dependent care assistance program) may not be taken into account for purposes of the credit.

(g) *Principal place of abode.* For purposes of this section, the term

principal place of abode has the same meaning as in section 152 and the regulations thereunder.

(h) *Maintenance of a household*—(1) *In general.* For taxable years beginning before January 1, 2005, the credit is available only to taxpayers who maintain households that include one or more qualifying individuals. A taxpayer maintains a household for the taxable year (or lesser period) only if the taxpayer (and spouse, if applicable) occupies the household and furnishes over one-half of the cost for the taxable year (or lesser period) of maintaining the household. The household must be the principal place of abode (within the meaning of section 152 and the regulations thereunder) for the taxable year of the taxpayer and the qualifying individual or individuals described in paragraph (b) of this section.

(2) *Cost of maintaining a household.* (i) Except as provided in paragraph (h)(2)(ii) of this section, for purposes of this section, the term cost of maintaining a household has the same meaning as in § 1.2–2(d) without regard to the last sentence thereof.

(ii) The cost of maintaining a household does not include the value of services performed in the household by the taxpayer or by a qualifying individual described in paragraph (b) of this section or any expense paid or reimbursed by another person.

(3) *Monthly proration of annual costs.* In determining the cost of maintaining a household for a period of less than a taxable year, the cost for the entire taxable year must be prorated on the basis of the number of calendar months within that period. A period of less than a calendar month is treated as a full calendar month.

(4) *Two or more families.* If two or more families occupy living quarters in common, each of the families is treated as maintaining a separate household. A taxpayer is maintaining a household if the taxpayer provides more than one-half of the cost of maintaining the separate household. For example, if two unrelated taxpayers with their respective children occupy living quarters in common and each taxpayer pays more than one-half of the household costs for each respective family, each taxpayer is treated as maintaining a household.

(i) Reserved.

(j) *Expenses qualifying as medical expenses*—(1) *In general.* A taxpayer may not take an amount into account as both an employment-related expense under section 21 and an expense for medical care under section 213.

(2) *Examples.* The provisions of this paragraph (j) are illustrated by the following examples:

Example 1. During 2004, L has \$6,500 of employment-related expenses for the care of his child who is physically incapable of self-care. The expenses are for services performed in L's household that also qualify as expenses for medical care under section 213. Of the total expenses, L may take into account \$3,000 under section 21. L may deduct the balance of the expenses, or \$3,500, as expenses for medical care under section 213 to the extent the expenses exceed 7.5 percent of L's adjusted gross income.

Example 2. The facts are the same as in *Example 1*, however, L first takes into account the \$6,500 of expenses under section 213. L deducts \$500 as an expense for medical care, which is the amount by which the expenses exceed 7.5 percent of his adjusted gross income. L may not take into account the \$6,000 balance as employment-related expenses under section 21 because he has taken the full amount of the expenses into account in computing the amount deductible under section 213.

(k) *Substantiation.* A taxpayer claiming a credit for employment-related expenses must maintain adequate records or other sufficient evidence to substantiate the expenses in accordance with section 6001 and the regulations thereunder.

(l) *Effective date.* This section and §§ 1.21–2 through 1.21–4 apply to taxable years ending after the date these regulations are published as final regulations in the **Federal Register**. However, taxpayers may apply this section and §§ 1.21–2 through 1.21–4 in taxable years for which the period of limitation on credit or refund under section 6511 has not expired as of May 24, 2006.

§ 1.21–2 Limitations on amount creditable.

(a) *Annual dollar limitation.* (1) The amount of employment-related expenses that may be taken into account under § 1.21–1(a) for any taxable year cannot exceed—

(i) \$2,400 (\$3,000 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there is one qualifying individual with respect to the taxpayer at any time during the taxable year; or

(ii) \$4,800 (\$6,000 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there are two or more qualifying individuals with respect to the taxpayer at any time during the taxable year.

(2) The amount determined under paragraph (a)(1) of this section is reduced by the aggregate amount excludable from gross income under section 129 for the taxable year.

(3) A taxpayer may take into account the total amount of employment-related

expenses that do not exceed the annual dollar limitation although the amount of employment-related expenses attributable to one qualifying individual exceeds 50 percent of the limitation. For example, a taxpayer with expenses in 2004 of \$4,000 for one qualifying individual and \$1,500 for a second qualifying individual may take into account the full \$5,500.

(4) A taxpayer is not required to prorate the annual dollar limitation if a qualifying individual ceases to qualify (for example, by turning age 13) during the taxable year. However, the taxpayer may take into account only expenses that qualify under § 1.21–1(a)(3) before the disqualifying event.

(b) *Earned income limitation*—(1) *In general.* The amount of employment-related expenses that may be taken into account under section 21 for any taxable year cannot exceed—

(i) For a taxpayer who is not married at the close of the taxable year, the taxpayer's earned income for the taxable year; or

(ii) For a taxpayer who is married at the close of the taxable year, the lesser of the taxpayer's earned income or the earned income of the taxpayer's spouse for the taxable year.

(2) *Determination of spouse.* For purposes of this paragraph (b), a taxpayer must take into account only the earned income of a spouse to whom the taxpayer is married at the close of the taxable year. The spouse's earned income for the entire taxable year is taken into account, however, even though the taxpayer and the spouse were married for only part of the taxable year. The taxpayer is not required to take into account the earned income of a spouse who died or was divorced or separated from the taxpayer during the taxable year. See § 1.21–3(b) for rules providing that certain married taxpayers legally separated or living apart are treated as not married.

(3) *Definition of earned income.* For purposes of this section, the term *earned income* has the same meaning as in section 32(c)(2) and the regulations thereunder.

(4) *Attribution of earned income to student or incapacitated spouse.* (i) For purposes of this section, a spouse is deemed, for each month during which the spouse is a full-time student or is a qualifying individual described in § 1.21–1(b)(1)(iii) or § .21–1(b)(2)(iii), to be gainfully employed and to have earned income of not less than—

(A) \$200 (\$250 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there is one qualifying individual with respect to the

taxpayer at any time during the taxable year; or

(B) \$400 (\$500 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there are two or more qualifying individuals with respect to the taxpayer at any time during the taxable year.

(ii) For purposes of this paragraph (b)(4), a full-time student is an individual who is enrolled at and attends an educational institution during each of 5 calendar months of the taxpayer's taxable year for the number of course hours considered to be a full-time course of study. The enrollment for 5 calendar months need not be consecutive. See section 152(f)(2) for taxable years beginning after December 31, 2004, or section 151(c)(4) for taxable years beginning before January 1, 2005, and the regulations thereunder.

(iii) Earned income may be attributed under this paragraph (b)(4), in the case of any husband and wife, to only one spouse in any month.

(c) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. In 2004, M, who is married, pays employment-related expenses of \$5,000 for the care of one qualifying individual. M's earned income for the taxable year is \$40,000 and her husband's earned income is \$2,000. M did not exclude any dependent care assistance under section 129. Under paragraph (b)(1) of this section, M may take into account under section 21 only the amount of employment-related expenses that does not exceed the lesser of her earned income or the earned income of her husband, or \$2,000.

Example 2. The facts are the same as in *Example 1* except that M's husband is a full-time student for 9 months of the taxable year and has no earned income. Under paragraph (b)(4) of this section, M's husband is deemed to have earned income of \$2,250. M may take into account \$2,250 of employment-related expenses under section 21.

Example 3. For all of 2004, N is a full-time student and O, N's husband, is an individual who is incapable of self-care (as defined in § 1.21-1(b)(1)(iii)). N and O have no earned income and pay expenses of \$5,000 for O's care. Under paragraph (b)(4) of this section, either N or O may be deemed to have \$3,000 of earned income. However, earned income may be attributed to only one spouse under paragraph (b)(4)(iii) of this section. Under the limitation in paragraph (b)(1)(ii) of this section, the lesser of N's or O's earned income is zero. N and O may not take the expenses into account under section 21.

(d) *Cross-reference.* For an additional limitation on the credit under section 21, see section 26.

§ 1.21-3 Special rules applicable to married taxpayers.

(a) *Joint return requirement.* No credit is allowed under section 21 for

taxpayers who are married (within the meaning of section 7703 and the regulations thereunder) at the close of the taxable year unless the taxpayer and spouse file a joint return for the taxable year. See section 6013 and the regulations thereunder relating to joint returns of income tax by husband and wife.

(b) *Taxpayers treated as not married.* The requirements of paragraph (a) of this section do not apply to a taxpayer who is legally separated under a decree of divorce or separate maintenance or who is treated as not married under section 7703(b) and the regulations thereunder (relating to certain married taxpayers living apart). A taxpayer who is treated as not married under this paragraph (b) is not required to take into account the earned income of the taxpayer(s) spouse for purposes of applying the earned income limitation on the amount of employment-related expenses under § 1.21-2(b).

(c) *Death of married taxpayer.* If a married taxpayer dies during the taxable year and the survivor may make a joint return with respect to the deceased spouse under section 6013(a)(3), the credit is allowed for the year only if a joint return is made. If, however, the surviving spouse remarries before the end of the taxable year in which the deceased spouse dies, a credit may be allowed on the decedent spouse(s) separate return.

§ 1.21-4 Payments to certain related individuals.

(a) *In general.* A credit is not allowed under section 21 for any amount paid by the taxpayer to an individual—

(1) For whom a deduction under section 151(c) (relating to deductions for personal exemptions for dependents) is allowable either to the taxpayer or the taxpayer's spouse for the taxable year;

(2) Who is a child of the taxpayer (within the meaning of section 152(f)(1) for taxable years beginning after December 31, 2004, and section 151(c)(3) for taxable years beginning before January 1, 2005) and is under age 19 at the close of the taxable year;

(3) Who is the spouse of the taxpayer at any time during the taxable year; or

(4) Who is the parent of the taxpayer's child who is a qualifying individual described in § 1.21-1(b)(1)(i) or § 1.21-1(b)(2)(i).

(b) *Payments to partnerships or other entities.* In general, paragraph (a) of this section does not apply to services performed by partnerships or other entities. If, however, the partnership or other entity is established or maintained primarily to avoid the application of paragraph (a) of this section to permit

the taxpayer to claim the credit, for purposes of section 21, the payments of employment-related expenses are treated as made directly to each partner or owner in proportion to that partner's or owner's ownership interest. Whether a partnership or other entity is established or maintained to avoid the application of paragraph (a) of this section is determined based on the facts and circumstances, including whether the partnership or other entity is established for the primary purpose of caring for the taxpayer's qualifying individual or providing household services to the taxpayer.

(c) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. P pays \$5,000 to her mother for the care of P's 5-year old child during 2004. The expenses otherwise qualify as employment-related expenses. P's mother is not her dependent. P may take into account under section 21 the amounts paid to her mother for the care of P's child.

Example 2. Q, who is divorced and has custody of his 5-year old child, pays \$6,000 during 2004 to R, who is his ex-wife and the child's mother, for the care of the child. The expenses otherwise qualify as employment-related expenses. Under paragraph (a)(4) of this section, Q may not take into account under section 21 the amounts paid to R because R is the child's mother.

Example 3. The facts are the same as in *Example 2*, except that R is not the mother of Q's child. Q may take into account under section 21 the amounts paid to R.

§§ 1.44A-1 through 1.44A-4 [Removed]

Par. 4. Sections 1.44A-1, 1.44A-2, 1.44A-3, and 1.44A-4 are removed.

§ 1.214-1 [Removed]

Par. 5. Section 1.214-1 is removed.

§§ 1.214A-1 through 1.214A-5 [Removed]

Par. 6. Sections 1.214A-1, 1.214A-2, 1.214A-3, 1.214A-4, and 1.214A-5 are removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 8. In § 602.101, paragraph (b) is amended by removing the entries for §§ 1.44A-1 and 1.44A-3.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

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