



SELECTED TAX PROVISIONS RELATED TO CHILDREN OF DIVORCE – PART I

By JOSEPH W. CUNNINGHAM, JD, CPA

The following presents basic information regarding two federal income provisions applicable to divorced or legally separated parents with one (or more) dependent child. In next month's column, additional child-related provisions will be presented.

Dependency Exemptions

General Rule

IRC Section 152(e) provides that if the parents, on a combined basis, (1) provide more than half a child's support for the year and (2) have physical custody for more than half the year, then the parent having physical custody for more than half the year (the custodial parent) is entitled to the exemption.

The custodial parent may "release" the exemption to the other parent by executing a written waiver for (1) one year, (2) a specific number of years, or (3) all future years. IRS Form 8332 is the waiver that the custodial parent must execute to release the exemption. The non-custodial parent must attach the executed Form 8332 to his/her tax return for the year(s) for which the exemption has been released.

Other Aspects of the Dependency Exemption

- The above applies to parents living apart for the last six months of the year as well as to divorced or legally separated parents.
- "Physical custody" for more than half the year is determined based on overnights. If overnights are equal, the parent with the higher adjusted gross income is deemed the custodial parent.
- The waiver can be used to, effectively, provide that the parents will claim the exemption in alternating years.
- Support provided by a parent's new spouse, or his/her parents, is deemed provided by the parent.
- The custodial parent may revoke the waiver by executing Part III of Form 8332. Such a revocation applies to the succeeding tax year.
- The federal income tax exemption amount is \$3,950 for 2014. It is also \$3,950 for 2013 Michigan Income Tax

(the amount for 2014 has not been released, but will not likely be less than \$3,950).

Phase-Out of the Tax Benefit of Personal and Dependency Exemptions

The phase-out of the tax benefit of personal and dependency exemptions for high income taxpayers was repealed for 2010-2012, but reinstated as of January 1, 2013.

The adjusted gross income (AGI) amounts at which the phase-out applies are as follows for 2014:

	Phase-Out Begins	Phase-Out Completed
Married Filing Jointly	\$305,050	\$427,550
Heads of Households	\$279,650	\$402,150
Unmarried/Single Taxpayers	\$254,200	\$376,700

A taxpayer's deduction for personal and dependency exemptions is reduced by 2% for each \$2,500, or fraction thereof, that his/her AGI exceeds the above threshold amounts.

Example: A single individual has a \$300,000 AGI. In addition to his personal exemption, his ex-wife has released the dependency exemption to him for their minor child who lives with her. The phase-out works as follows:

- Two exemption deductions unreduced – $2 \times \$3,950 = \$7,900$
- Number of \$2,500 amounts, or a fraction thereof, by which AGI exceeds threshold - $\$300,000 - \$254,200 / \$2,500 = 19$
- Percent reduction in exemption deduction – $2\% \times 19 = 38\%$
- Reduced exemption deductions – $100\% - 38\% = 62\% \times \$7,900 = \$4,898$

Practice Pointers

- **Use Release of Dependency Exemption as Leverage** – If otherwise advantageous, provide for execution of the waiver releasing the dependency exemption to the non-custodial spouse subject to payment of child support in full and on time.

- **Maximize Tax Benefit from Dependency Exemption** – Obviously, the parent with the higher taxable income will generally save more in taxes by deducting the dependency deduction than the other parent. Also, unless remarried, many non-custodial parents file as single taxpayers, subject to higher rates than the head of household rates applicable to most custodial parents.
- **Be Mindful of Phase-Out** – It benefits no one if the dependency exemption deduction is claimed by a parent – custodial or non-custodial – who loses all or a considerable portion of the deduction due to an AGI exceeding the phase-out threshold.
- **“Sale” of the Dependency Exemption** – A custodial parent may consider “selling” the dependency exemption to the other parent in the higher tax bracket. Correspondingly, the noncustodial parent may initiate discussion of “purchasing” the deduction. The price should be no less than the federal and state tax benefits the custodial parent loses by not claiming the deduction – including the Child Tax Credit (see below).

Child Tax Credit

Pursuant to IRC Section 24, a parent with AGI less than the statutory limit noted below may claim the Child Tax Credit (Credit) for one or more “qualifying” children.

“Qualifying Child” – Child of a parent who:

- Is the parent’s son, daughter, step-child, sibling, step-sibling, or any descendant of the foregoing;
- Was under age 17 at year-end;
- Did not provide more than half of his/her support;
- Lived with the parent more than half the year;
- Is claimed as a dependent by the parent;
- Does not file a joint return for the year; and,
- Is a US citizen, US national, or a US resident alien.

Amount of the Credit – The Credit is \$1,000 for each qualifying child. However, the Credit is reduced by \$50 for each \$1,000, or fraction thereof, that the parent’s AGI exceeds:

- Married Filing Jointly-\$110,000
- Filing as Single or Head of Household-\$75,000

Thus, if AGI exceeds the above amounts by \$10,000, the credit is reduced by 50%. It’s fully eliminated if AGI is \$20,000 or more above the \$75,000 or \$110,000 statutory amount.

Example: Single parent with one qualifying child has an AGI of \$85,000.

- Unreduced Child Tax Credit \$1,000
- Reduction - \$85,000 - \$75,000/\$1,000 x \$50 (500)
- Reduced Child Tax Credit \$ 500

Other Aspects of the Child Tax Credit

- One of the “qualifying child” requirements is that the child lives with the parent for more than half the year. Thus, the custodial parent is entitled to the Credit.
- If the custodial parent releases the dependency exemption for a qualifying child to the non-custodial parent, then the latter is entitled to the Credit, subject, of course, to possible reduction if his/her AGI exceeds the statutory amounts noted above.
- Thus, the Credit follows the dependency exemption.
- The Credit is refundable if it exceeds the parent’s tax liability to the extent of 15% of his/her *earned income* in excess of the statutory amount – currently \$3,000.

Practice Pointers

- **Credit Is Part of Waiver Decision** - Since the Credit follows the dependency exemption, the custodial parent should consider loss of an otherwise available credit as one of the tax saving benefits foregone if the exemption is released to the non-custodial parent.
- **Earned Income Required for Refund of Credit** - A stay-at-home parent receiving spousal and/or child support who has no earned income will not be entitled to a refund of the Credit in excess of his/her tax liability.
- **Lower Phase-Out Amounts** - The AGI levels at which the Credit is reduced are much lower than those applicable to dependency exemptions noted above. Thus, similar to determining whether filing jointly or separately for the year of divorce settlement is more advantageous, in some cases one must “run the numbers” both ways concerning the decision to release the exemption and forgo the Credit.

About the Author

Joe Cunningham has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy though his practice is statewide.