



TAX TRENDS AND DEVELOPMENTS

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The following presents basic information on four federal income provisions relating to divorced or legally separated parents providing child support for one (or more) dependent child. These provisions (1) often provide significant tax savings – particularly to parties of modest means – and (2) are often overlooked by divorce counsel who can provide a valuable service by advising clients to check to see if they qualify for any of such tax benefits.

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 \$4,000 for 2015.

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

The tax benefit of personal and dependency exemptions is phased out for high income taxpayers.

The adjusted gross income (AGI) amounts at which the phase-out applies are as follows for 2015:

<u>Filing Status</u>	<u>AGI Beginning of Phaseout</u>	<u>AGI Completed Phaseout</u>
Married Individuals Filing Joint Returns and Surviving Spouses	\$309,900	\$432,400
Heads of Households	\$284,050	\$406,550
Unmarried Individuals (other than Surviving Spouses and Heads of Households)	\$258,250	\$380,750
Married Individuals Filing Separate Returns	\$154,950	\$216,200

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 x \$4,000 = \$8,000

- Number of \$2,500 amounts, or a fraction thereof, by which AGI exceeds threshold - $\$300,000 - \$258,2500/\$2,500 = 17$
- Percent reduction in exemption deduction – $2\% \times 17 = 34\%$
- Reduced exemption deductions – $100\% - 34\% = 66\%$
x \$8,000 = \$5,280

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 IRS 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 own support;
- Lived with the parent more than half the year;

- Is claimed as a dependent by the parent;
- Does not file a joint tax 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 is 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 - $\$85,000 - \$75,000/\$1,000 \times 50$ (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 her/his AGI exceeds the statutory amounts noted above.
- Thus, the Credit tracks with 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 tracks with the dependency exemption, the custodial parent should consider loss of an otherwise available credit as one of the tax saving benefits forgone 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.

Earned Income Credit

General Rule

IRS Section 32 provides for a refundable tax credit for taxpayers (1) with adjusted gross incomes (AGIs) under certain limits and (2) who have earned income. As indicated below, the credit increases significantly for taxpayers with one or more qualifying children.

To qualify, a taxpayer’s 2014 AGI must be less than:

- \$14,820 (\$20,330 if married filing jointly) with no qualifying children
- \$39,131 (\$44,651 if married filing jointly) with one qualifying child
- \$44,454 (\$49,974 if married filing jointly) with two qualifying children
- \$47,747 (\$53,267 if married filing jointly) with three or more qualifying children

The credit begins to phase out for taxpayers with one or more qualifying children who have a 2014 AGI of \$17,530 or more and an AGI of \$7,970 or more if no qualifying children. The phase-out continues from these AGIs through the amounts shown above. The above phase out amounts will be adjusted for inflation for 2015.

Also, a taxpayer’s investment income – interest, dividends, capital gain, etc. – cannot exceed \$3,350 in 2014.

The maximum credit for 2015:

- \$503 with no qualifying children
- \$3,359 with one qualifying child
- \$5,548 with two qualifying children
- \$6,242 with three or more qualifying children

The requirements for “qualifying child” are essentially the same for claiming a dependency exemption for a child.

“Earned income” includes salaries, wages, other forms of employee compensation, and self-employment income.

The IRS will calculate the credit. For taxpayers who want to calculate the credit, there are tables included in both 1040 and 1040A instructions.

Example: John and Mary, who file jointly, have:

- Earned income of \$25,000.
- Investment income of \$1,000
- Two qualifying children

Because their \$26,000 AGI is less than the \$49,974 limit and their \$1,000 investment income does not exceed \$3,350, they are entitled to the earned income credit (EIC) in excess of \$5,000.

Practice Pointers

- As shown by the example, the EIC can be considerable for taxpayers with one or more children who have AGIs less than the phase out income range shown above. Thus, attorneys should alert clients with low to moderate incomes to check on qualification for the EIC.
- Since the EIC applies annually provided qualifications are satisfied, it should be considered as a positive post-divorce budget item for clients of modest means.

Child and Dependent Care Credit

General Rule

IRS Section 21 provides for a non-refundable credit against income tax of up to 35% of expenses for the care of a dependent child under age 13 which are incurred to enable the taxpayer to be gainfully employed.

Such expenses are limited to \$3,000 per qualifying child. Qualifying expenses include household services and the direct care of a child.

The percentage applied to the credit is 35% for a taxpayer with an AGI of \$15,000 or less. The percentage is reduced by 1% for every \$2,000 of AGI – or a fraction thereof – above \$15,000, as shown on the table below. The minimum percentage is 20%, applicable to those with AGIs exceeding \$43,000.

Example: A taxpayer spends \$5,000 on qualifying child care expenses for two dependent children so that she can work as an assistant manager. Her AGI is \$30,000. Her Child Care credit is - \$5,000 x 27% = \$1,350. This amount will reduce her taxes dollar for dollar.

Other Aspects of the Child and Dependent Care Credit

As the name indicates, the credit also applies to qualifying expenses if the dependent is a child or relative 13 of age or older, or a spouse, if he or she is physically or mentally

unable to care for himself or herself and resides with the taxpayer more than half the year.

Qualified expenses are considered only to the extent of a taxpayer's earned income. For married taxpayers, qualified expenses are limited to the earned income of the lesser earning spouse.

The credit is claimed by completing IRS Form 2441.

Child and Dependent Care Credit Table

AGI	Credit	One Child	Two or More
\$15,000	35%	\$1,050	\$2,100
\$15,001 – 17,000	34%	\$1,020	\$2,040
\$17,001 – 19,000	33%	\$990	\$1,980
\$19,001 – 21,000	32%	\$960	\$1,920
\$21,001 – 23,000	31%	\$930	\$1,860
\$23,001 – 25,000	30%	\$900	\$1,800
\$25,001 – 27,000	29%	\$870	\$1,740
\$27,001 – 29,000	28%	\$840	\$1,680
\$29,001 – 31,000	27%	\$810	\$1,620
\$31,001 – 33,000	26%	\$780	\$1,560
\$33,001 – 35,000	25%	\$750	\$1,500
\$35,001 – 37,000	24%	\$720	\$1,440
\$37,001 – 39,000	23%	\$690	\$1,380
\$39,001 – 41,000	22%	\$660	\$1,320
\$41,001 – 43,000	21%	\$630	\$1,260
\$43,001 or more	20%	\$600	\$1,200

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.