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**CHILD RELATED TAX BREAKS FOR
DIVORCED PARENTS**

Introduction

Determining the tax treatment of children is complicated, since the rules are always changing. Adding a divorce to the situation gives rise to several more questions and concerns. While it is comforting to know that a tax professional can always be consulted, it is necessary for divorce professionals to be aware of the basic tax implications that arise in common situations.

Divorce professionals should keep up with the changes in the tax laws that impact divorce. Financial situations are bound to change, and it is probably necessary to review individual tax plans to make sure the client is maximizing benefits, while minimizing liability. While there are many tax implications due to a divorce, this article focuses on several important tax attributes in respect to children. The first half of the article provides an overview of the tax credits and exemptions available to either parent. The second half suggests tax benefits that may be available to only a specified parent.

I. Tax Benefits Available to Either Parent

A. Dependency Exemption¹

Determining which parent is allowed to claim the dependency exemption can be a frustrating process. Generally, in cases of divorce, the parent who has custody of the child for more than one-half the year is considered the custodial parent,² and can claim the child as a “qualifying child”³ for certain tax

¹ I.R.C. § 151(c) (2008).

² I.R.C. § 152(e)(4)(A) (2008).

³ Section 152(e) defines a taxpayer’s “qualifying child” if the child: 1) is the taxpayer’s child, stepchild, foster child, etc.; 2) shares the same principal residence for more than half the year; 3) is under age 19 at the end of the year or, if a full time student, under age 24 for a minimum of five months of the year; 4) did not provide more than fifty percent of his or her own support for the year. *Id.* This definition also applies to the child tax credit, child care credit, earned income credit, and head of household filing status.

breaks.⁴ The rule presumes that the custodial parent provides more than half of the child's support and is entitled to the dependency exemption.⁵

Under certain circumstances, a special rule applies to children of divorced or separated parents, allowing the noncustodial parent to claim the exemption.⁶ The qualifying child can be treated as the noncustodial parent's dependent when: 1) the parents are divorced or legally separated under a written agreement, or lived apart continuously during the last six months of the year; 2) the child received more than half of his support from the parents for the year; 3) the child has been in the custody of either one or both parents for the greater part of the year; and 4) the custodial parent releases the claim to the exemption to the noncustodial parent in a written declaration, which must be attached to the noncustodial parent's tax return.⁷

When the noncustodial parent claims the exemption, it is generally based on a court order or due to an agreement between spouses. Jurisdictions vary on whether courts have discretion to allocate the exemption between spouses in a divorce action. A growing majority has consistently held that courts may use their equitable powers to order a custodial parent to execute a waiver of the exemption, permitting the noncustodial parent to claim it.⁸ Only a handful of states hold that trial courts have no authority to allocate the exemption, including: Texas,⁹ Georgia,¹⁰ Virginia,¹¹ and South Dakota.¹² However, courts that do not allo-

⁴ See I.R.S., U.S. Dep't of Treasury, Publ'n 501, Exemptions, Standard Deduction, and Filing Information 13 (rev. Dec. 2008) [hereinafter Publ'n 501].

⁵ *Id.*

⁶ I.R.S., U.S. Dep't of Treasury, Publ'n 504, Divorced or Separated Individuals 8 (rev. Feb. 2009).

⁷ *Id.* A written declaration can be a Form 8332 or a similar statement signed by the custodial parent and whose only purpose is to release a claim to exemption *id.* Beginning in 2009, the IRS will not accept the noncustodial parent's attachment of the divorce decree or agreement to satisfy the written declaration requirement. *Id.*

⁸ Miller v. Miller, 744 A.2d 778 (Pa. Super. Ct. 1999).

⁹ Davis v. Fair, 707 S.W.2d 711, 717 (Tex. App. 1986); Durden v. McClure, 2008 Tex. App. LEXIS 8683 (Tex. App. Nov. 19, 2008).

¹⁰ Bradley v. Bradley, 512 S.E.2d 248, 249 (Ga. 1999).

¹¹ Floyd v. Floyd, 436 S.E.2d 457, 463 (Va. 1993).

¹² Brandriet v. Larsen, 442 N.W.2d 455, 460 (S.D. 1989).

cate the exemption may, in certain situations, order the custodial parent to execute the waiver.¹³

When former spouses are able to come to an agreement, the exemption does allow for some flexibility, not to mention an effective bargaining chip. It is commonly prudent to assign the exemption to the higher income parent, because he or she will receive greater tax benefits.¹⁴ In this case, if the lower income parent is the custodial parent receiving child support, he or she can release the exemption to the former spouse in exchange for something else, i.e. increase child support payments. The custodial parent is also able to release the exemption for one year, multiple years, or for all future years.¹⁵ If more than one year is chosen, then a copy of the original release must be attached for later years. Whichever is agreed upon between the spouses should be evident in the divorce decree.

B. Child Tax Credit

The child tax credit is available for taxpayers to be able to reduce up to one-thousand dollars of the amount of income tax owed.¹⁶ Only one parent is entitled to this credit for each qualifying child that is under age seventeen at the year's end.¹⁷ This credit is used by the parent that claims the dependency exemption. If the custodial parent releases the exemption, then that parent is no longer able to use the child tax credit. Similarly, if the noncustodial parent is claiming the exemption, then he or she may also use the child tax credit.¹⁸ When negotiating the dependency exemption, it is important to pay special attention to the credit's limitations.¹⁹ If the parent's adjusted gross income is over a certain threshold amount, then that parent will not be able to take full advantage of the credit.²⁰ Since the full credit is reduced fifty dollars for every \$1,000 above the threshold,²¹ a single

¹³ Prenatt v. Stevens, 598 N.E.2d 616 (Ind. Ct. App. 1992).

¹⁴ I.R.C. § 151(d)(3) (2008).

¹⁵ Publ'n 501, *supra* note 4, at 8.

¹⁶ I.R.C. § 24(a) (2008).

¹⁷ *Id.* § 24(c).

¹⁸ Publ'n 501, *supra* note 4, at 9.

¹⁹ I.R.C. § 24(b)(1) (2008).

²⁰ *Id.* § 24(b)(2). A single taxpayer with an adjusted gross income above \$75,000 is ineligible to claim the child tax credit.

²¹ *Id.* § 24(b).

parent with an adjusted gross income of \$85,000 is limited to a \$500 child tax credit. Accordingly, it may provide more benefit to award the exemption and credit to the lower income parent.

The child tax credit is fairly straight forward since it travels with the exemption. If a custodial parent releases the exemption, but the noncustodial parent does not satisfy all requirements, like attaching the Form 8332, then just as the noncustodial parent is not entitled to the exemption, he or she is also not entitled to the child tax credit.

Situations may arise that result in certain tax benefits being available to one parent and not the other. Whereas the foregoing benefits may be available to either the custodial or noncustodial parent, the following tax implications can only be taken advantage of by the custodial parent. However, situations may arise that result in neither parent being eligible for the tax benefit. Careful planning is important to make sure all available benefits are being utilized.

II. Tax Benefits Available to a Specified Parent

A. Child Care Credit

If a parent paid someone to care for his or her child so he or she could work and earn income for the year, then that parent may be able to take the credit for child care expenses.²² While specific requirements must be met, special rules apply in a situation of divorce or separation.²³ A parent is entitled to the child care credit even if he or she is not claiming the child for dependency exemption purposes as long as two requirements are satisfied.²⁴ First, the child being qualified must be under age thirteen or disabled.²⁵ Second, the parent claiming the credit must be the child's custodial parent.²⁶ Accordingly, the noncustodial parent, even if claiming the dependency exemption, may not treat the child as a qualifying child, and thus is not entitled to the child care credit.²⁷ In addition, the special rule does not require the

²² I.R.C. § 21 (2007).

²³ *Id.* § 21(e)(5).

²⁴ *Id.*

²⁵ *Id.* § 21(b)(1)(A).

²⁶ Treas. Reg. § 1.21-1(b)(5) (2007).

²⁷ See Publ'n 501, *supra* note 4, at 13.

parent claiming the child care credit to maintain a household in order to claim the credit.

B. *Filing Status*

Filing status is used to determine how much tax is owed, as well as determining whether the taxpayer is eligible for any deductions and credits. Since taxpayers are sometimes eligible for more than one status, it is important to determine which provides the least tax liability. It is also important to note that an individual's "marital status on the last day of the year determines the filing status for the entire year."²⁸ Those considered divorced or separated generally file as single. However, if a dependent child lives at a house where the parent not only pays for more than half of the cost of keeping up the home for the year, but also provides most of the child's support, then filing head of household is a possibility.²⁹ The head of household status usually provides for lower tax rates and higher standard deduction than the single status.

Since a child can only qualify one parent, it is not possible for both parents to file as head of household. "For a noncustodial parent, 'qualifying child' for head of household filing status does not include a child that is a qualifying child for exemption purposes."³⁰ In other words, a custodial parent that releases the exemption can still claim the child as a qualifying child for head of household filing status.

C. *Earned Income Credit*³¹

Only one parent can claim a single child as the qualifying child³² when taking the earned income credit. Generally, the custodial parent will elect to claim the child, so long as the other requirements are met. Even when the noncustodial parent claims the child for the dependency exemption and child tax credit, he or she may not claim that qualified child for the earned income credit.

²⁸ *Id.* at 2.

²⁹ I.R.C. § 2(b)(1) (2008).

³⁰ Publ'n 501, *supra* note 4.

³¹ I.R.C. § 32 (2008).

³² *See supra* text accompanying note 3.

Different schedules are used to determine the tax credit depending on the number of qualifying children. If the parent has one qualifying child and has earned less than \$33,995, then that parent may be eligible to take the earned income credit.³³ If the parent has more than one qualifying child, then the parent is only eligible for the tax credit if he or she has earned less than \$38,646 for the year.³⁴

There are some considerations, which if overlooked, can cause the parent to lose the election. The credit is not available for those who are married filing separately. If a divorce decree has not been finalized by the end of the year, but spouses have been living separately for the last six months, filing head of household may allow for the election.³⁵ Also, the custodial parent can still be eligible for the tax credit even if that parent did not take the dependency exemption.³⁶ Finally, the earned income credit is not available if a parent happens to be a qualifying child of another person, regardless of that person actually being eligible to take the credit.³⁷

D. *Education Benefits*

Among the variety of education related tax benefits available, a few require some attention when the parties are going through a divorce. When deciding who takes the dependency exemption, it is important to keep in mind that several tax benefits for education expenses³⁸ travel with the exemption, like the hope credit and the lifetime learning credit. If a parent is paying the child's education expenses and claiming the child for the dependency exemption, then he or she may be allowed to claim one of the credits per child each year.³⁹

³³ I.R.S., U.S. Dep't of Treasury, Publ'n 596, Earned Income Credit 2 (rev. Mar. 2009).

³⁴ *Id.* at 3.

³⁵ *Id.* at 18.

³⁶ *Id.*

³⁷ *Id.* at 19.

³⁸ Qualified education expenses include tuition and fees, and expenses for required books and equipment if required to be paid to the educational institution as a condition of enrollment or attendance. I.R.C. § 25A(f)(1) (2008).

³⁹ See I.R.C. §§ 25A(g)(3), 25A(g)(5) (2008).

The hope credit provides up to a \$1,800 of credit each year for only the first two years of the child's higher education.⁴⁰ The credit can be taken for each child, as long as the child is enrolled at least part time.⁴¹ This credit is only available for the first two years of post-secondary education.⁴²

The lifetime learning credit provides up to \$2,000 per year, and it is available during post-secondary education, as well as courses "to acquire or improve job skills."⁴³ Contrary to the hope credit, the lifetime learning credit does not require the child-student to pursue a degree.⁴⁴ This credit is available for an unlimited number of years, and is available for one or more courses.⁴⁵

Divorced parents should discuss who is taking the credit and which one for each child each year.⁴⁶ Since neither parent can claim both educational credits on any single child the same year,⁴⁷ proper tax planning with the other parent may need to be agreed upon in advance. If one parent pays the education expenses and the other parent is claiming the dependency exemption, then the education benefits will be lost. After all, the ultimate goal here is, or at least should be, to reap the maximum tax benefit.

In addition to the education-related credits, another tax benefit can arise from Coverdell Education Savings Account (ESA), formally known as an Education IRA.⁴⁸ An ESA is "a trust or custodial account created or organized in the United States only for the purpose of paying the qualified education expenses of the

⁴⁰ I.R.C. § 25A(b) (2008).

⁴¹ *Id.* § 25A(b)(2).

⁴² *Id.* § 25A(b)(2)(C).

⁴³ *Id.* § 25A(c).

⁴⁴ I.R.S., U.S. Dep't of Treasury, Publ'n 970, Tax Benefit for Education 19 (rev. Jan. 2009) [hereinafter Publ'n 970].

⁴⁵ *Id.*

⁴⁶ Both credits are reduced for taxpayers with an adjusted gross income over \$48,000, and are completely eliminated if above \$58,000. I.R.C. § 25A(d) (2008).

⁴⁷ A parent may not claim a hope credit and a lifetime learning credit based on the same qualified education expense. *Id.* §§ 25A(c)(2)(A), 25A(g)(5).

⁴⁸ Publ'n 970, *supra* note 44, at 43.

designated beneficiary of the account.”⁴⁹ This account can be opened for any beneficiary under age 18.⁵⁰

Anyone can contribute to the designated child beneficiary’s account. Though the contributions are not deductible, the distributions are tax-free if used for higher education expenses.⁵¹ The contribution limit per child beneficiary is \$2,000, regardless of how many ESAs are set up for that beneficiary and how many individuals contribute.⁵² So if one contributor donated \$2,000 to one designated beneficiary, then no one else can contribute to that same beneficiary.

Anything contributed to the account above the limit will be taxed to the beneficiary, unless the excess amount is distributed for qualified education expenses before the sixth month of the following tax year.⁵³ To avoid unnecessary tax on the excess amounts, divorced parent contributors should be aware of the annual limit and agree on each contribution amount without going over the limit. If there is excess in the account, distributions will be tax free as long as they are not more than the beneficiary’s adjusted qualified education expenses.

E. *Unearned Income of Minors*

Generally, a child is responsible for filing his or her own tax return, unless the child is not able to for reasons such as age, in which case the child’s parent is responsible for filing a return on his or her behalf. When a child has only unearned income for the year, the parent may be able to include that income on his or her return rather than filing a separate return for the child.⁵⁴ The election can be taken subject to the following requirements: the child must be under 19 years old, or under 24 if a full-time student; the child’s gross income must be less than \$9,000 for the

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* at 44.

⁵² *Id.* at 45.

⁵³ *Id.* at 47.

⁵⁴ I.R.S., U.S. Dep’t of Treasury, Publ’n 929, Tax Rules for Children and Dependents 7 (rev. Jan. 2009). If a parent includes a child’s unearned income on the parent’s tax return, only the amount over \$1,800 is included in the parent’s income and subject to a higher tax rate. The first \$1,800 of the child’s unearned income is taxed at the child’s rate and then added to the tax figured in the parent’s income. *Id.* at 8.

year; the income is only classified as unearned income (interest and dividends); the child is required to file a tax return unless the election is made; the child cannot be filing a joint return for the year; and the parent whose return must be used conforms with the special tax rules for children.⁵⁵ When the child's parents are divorced, the tax return of the custodial parent, if not remarried, is used.⁵⁶

The custodial parent should be aware of consequences if the election is taken. In some situations where the parent's adjusted gross income will increase, it may affect his or her eligibility to claim certain credits and deductions that phase out as income grows. Careful planning whether to make this election is needed to avoid a reduced amount or a complete loss of previously mentioned tax benefits.

F. "Kiddie Tax"

Parents try to shift some of their taxable income to their child in order to benefit from the child's lower tax rates.⁵⁷ However, recent rules have prevented this, or at least made it harder for the parents to make the transfer.⁵⁸ The rules of the kiddie tax discourage parents approach to income-shifting by taxing a portion of the child's investment income at the parent's higher rate.⁵⁹ In divorce situations, the custodial parent's income should be taken into account when applying the kiddie tax.⁶⁰ So a child's earned income, such as salary or wages that a child earns through employment, as well as any unearned income the child has below a specified amount, \$1,900 for 2009, are taxed at the child's tax rate. However, any unearned income above that specified amount will be taxed at the custodial parent's tax rate.

⁵⁵ *Id.*

⁵⁶ *Id.* at 6. This is the case regardless of whether the custodial parent claims the child as a dependent.

⁵⁷ If parents are trying to shift income to children to save money for education purposes, they might be hit with the kiddie tax. A better alternative may be to put the money in Coverdell instead.

⁵⁸ Only recently has the kiddie tax expanded to affect older children. Beginning in 2008, this tax applies to all children under age 19, and any children between the ages of 19 and 23 if they are full-time students, earning income that does not exceed half of their support for the year.

⁵⁹ I.R.C. § 1(g)(5) (2008).

⁶⁰ *Id.*

Since the responsibility for filing the child's tax return falls in the hands of the custodial parent,⁶¹ it may be important to consider the tax payment on a child's unearned income when reaching a divorce settlement agreement. If the custodial parent is responsible for paying the extra tax on the child's unearned income, it may be appropriate to increase child support to cover those costs.

G. *Collection of Child Support*

When collecting child support, it is important to consider the tax implications of each type of distribution. Typically, the receiving parent gets tax-free money, while the parent paying the support incurs a nondeductible expense. While a variety of methods are common, there is one that is often overlooked for collection of child support: a Qualified Domestic Relations Order (QDRO).⁶² "A QDRO is defined as a judgment, decree, or order which relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child or other dependent of a participant and is made pursuant to a state domestic relations law."⁶³

While the QDRO is a valuable tool, it must be used with care. To avoid complications, the divorce decree should clearly state its use, whether it is for child support or something else. Additionally, it is important to address who is responsible for paying the income taxes on the distributions. Generally, if utilized for child support payments, the QDRO will treat it according to the Internal Revenue Code: nondeductible to the payor and nontaxable to the recipient.⁶⁴ A QDRO, when properly drafted, will provide for a useful means in the collection of child support.

⁶¹ I.R.C. § 6012(b) (2008).

⁶² See, e.g. *Jones v. Treasure*, 984 So.2d 634 (Fla. Dist. Ct. App. 2008); *Marriage of Thomas*, 789 N.E.2d 821 (Ill. App. Ct. 2003); *In re Marriage of Cook*, 884 N.E.2d 877 (Ind. Ct. App. 2008); *Albertson v. Ryder*, 621 N.E.2d 480 (Ohio Ct. App. 1993).

⁶³ 29 D.S.C. § 1056(d)(3)(B)(ii)(I) (2008).

⁶⁴ I.R.C. § 71(c) (2007).

III. Conclusion

Due to the complexity of a divorce, many tax issues regarding children are often times overlooked, resulting in a loss of tax benefits to either or both parents, and possible complications later on down the road. It is important to determine which parent is eligible for the various tax benefits. Some benefits are available only to the custodial parent, while others may be available to either parent depending on the circumstances. As each case varies, the common goal is to show how much total tax can be saved by either or both parents.

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