



Crafting Tax-Compliant Divorce and Custody Settlements

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NOTRE DAME TAX CLINIC

Overview

- I. Tax Benefits for Claiming Dependents
- II. Dependency Rules
- III. Dependency Rules in Divorce
- IV. Pitfalls and Tips

Tax Benefits for Claiming Dependents

I. Dependency Exemption/Credit

- ▶ Federal: \$0 deduction (2018 through 2025)
- ▶ \$1,000/\$2,500 deduction (Indiana)

II. Head of Household Filing Status

- ▶ Higher standard deduction (\$9,300 vs. \$6,300 for single filers)
- ▶ Favorable tax brackets vs. single filers
- ▶ No Indiana tax benefit

Tax Benefits for Claiming Dependents

III. Earned Income Credit

- ▶ Up to \$6,431 refundable tax credit (federal)
- ▶ Up to \$579 refundable tax credit (Indiana)

IV. Child Tax Credit

- ▶ Up to \$2,000 (\$1,400 refundable) tax credit per child (2018 – 2025)
 - ▶ **Greatly** increased phaseout range. Taxpayers up to \$440,000 if married filing jointly may now qualify (previously \$130,000).
 - ▶ If only a “Qualifying Relative” can qualify for \$500 nonrefundable “dependent credit”.
- ▶ No Indiana tax benefit

Tax Benefits – Example

Example: A married couple with two children earning \$35,000 in 2018 will owe \$1,100 in federal income tax.

They will receive a \$1,100 Child Tax Credit; \$2,800 refundable Child Tax Credit; and a \$3,195 Earned Income Credit.

Tax Owed		\$1,100
<i>Less Credits</i>	Nonrefundable Child Tax Credit	\$1,100
	Refundable Child Tax Credit	\$1,400
	Refundable Child Tax Credit	\$1,400
	Earned Income Credit	\$3,195
	<u>Total Credits</u>	<u>\$7,095</u>
Total Tax Owed/(Refund)		(\$5,995)

Tax Benefits – Example (No Children)

If the couple couldn't claim any children, they would NOT qualify for a refund. Instead, they would owe \$1,100 in federal.

Thus, the total value of the child-based tax benefits are **\$7,095**.

Dependency Rules

All dependent tax benefits derive from **IRC § 152**.

Dependency Exemptions – IRC §§ 151, 152

1. General Tests
 1. Taxpayer not a dependent themselves
 2. Dependent cannot generally be married
 3. Dependent is a US citizen or tax resident
2. “Qualifying Child” or “Qualifying Relative” (IRC § 152(a))

Dependency Rules

“Qualifying Child” – IRC § 152(c) – Must meet ALL of the following:

- ▶ Relationship Test: Children, siblings, and descendants.
- ▶ Abode Test: Lived with taxpayer more than ½ of the year.
- ▶ Age Test: Less than 19 years old, or 24 if a full time student.
- ▶ Support Test: Dependent doesn't support themselves.

Dependency Rules

“Qualifying Relative” – IRC § 152(d) – Must meet ALL of the following:

- ▶ Relationship Test: All relatives except cousins; anyone who resides with taxpayer more than ½ of the year.
- ▶ Support Test: Taxpayer provides over 50% of support.
- ▶ Gross Income Test: Dependent's gross income is less than \$4,150
- ▶ Not a Qualifying Child Test: Dependent not a qualifying child of anyone.

Filing Status

Overview: 5 Filing Statuses

1. Single
2. Married Filing Jointly
3. Married Filing Separately
4. Head of Household
5. Qualifying Widow(er) with Dependent Child

Tax Benefit: \$18,000 standard deduction (vs. \$12,000 for single filers). \$600 benefit for 10% bracket. Additionally, favorable tax rates.

NOT an assignable item in divorce or custody disputes.

Filing Status – Head of Household

Requirements – IRC § 2(b)

1. Single
 - ▶ Exception: Can be legally married, but lived apart from spouse for last 6 months of tax year.
2. Has a qualifying dependent that spends > 50% of the year in household
 - ▶ Can be Qualifying Child or Qualifying Relative
3. Provides > 50% of the costs of maintaining the household
4. Is a US citizen or tax resident

Earned Income Credit – IRC § 32

Overview

- ▶ Refundable credit for low-income workers
- ▶ Increases with income, then phases out for higher income levels
- ▶ Increases with number of children
- ▶ Phaseout range higher for married couples.
- ▶ Can claim without children, but very limited

Earned Income Credit – IRC § 32

Eligible Individual

- ▶ Social Security Numbers for everyone on the return. IRC § 32(m)
- ▶ If married, must file jointly or HOH, if lived apart last 6 months of the year. See IRC §§ 32(d), 7702.
- ▶ “Earned” Income: Wages or self-employment.
- ▶ “Qualifying Child”: Same as under IRC § 152(c), except no Support Test.
- ▶ **Not an assignable item in divorce**

Child Tax Credit – IRC § 24

Overview

- ▶ Refundable credit for taxpayers with Qualifying Children
- ▶ Phase-in at very low income levels
- ▶ Phase-out at very high income levels

Tax Benefit: (2018 – 2025): \$2,000 per qualifying child (\$1,400 refundable). Refundable portion adjusted for inflation.

Child Tax Credit – IRC § 24

Qualifying Child – IRC § 24(c)

- ▶ Qualifying Child Rules for Dependency Exemption, plus
- ▶ Age Test: < 17 years old
- ▶ Residency Test: No CTC for children living outside the United States.
- ▶ **CTC is an “assignable” item in a divorce or custody agreement/decre.**
- ▶ 2018 – 2025:
 - ▶ May only claim children with Social Security numbers (though taxpayers may have an ITIN)

Child Tax Credit – IRC § 24

Dependent Credit – IRC § 24(h)(4)

- ▶ \$500 nonrefundable credit
- ▶ Only if child does NOT qualify for Child Tax Credit (generally Qualifying Relatives and Qualifying Children > age 16)
- ▶ NOT in addition to the Child Tax Credit

Dependency Rules in Divorce

IRC § 152(e) – Special Rules for “Divorced” Parents

- ▶ Applies if (1) the dependent received >50% of support from their parents, (2) the child is in the custody of 1 or both of the parents for > ½ of the tax year, and (3) the parents:
 - ▶ Are divorced or legally separated at any point in the tax year, or
 - ▶ Live apart during the last 6 months of the tax year.
- ▶ The **Non-Custodial parent** may receive the dependency exemption/credit and Child Tax Credit, if the **Custodial parent** agrees.

Dependency Rules in Divorce

“Custodial parent” can agree (but is not required to agree) to grant the Non-Custodial parent the right to claim:

1. Child Tax Credit, and
2. Dependency Credit

NOT: The Earned Income Credit or Head of Household status.

“Custodial Parent”: The parent who had custody for the “greater portion of the calendar year.”

Dependency Rules in Divorce – Tax Reform Summary

Tax Benefit	Potential Value (10% Bracket Taxpayer)	Custodial Parent	Non-Custodial Parent
Dependency Exemption	\$0	Yes	Yes, with a signed Form 8332
Dependency Credit	Up to \$500 credit	Yes	Yes, with a signed Form 8332
Head of Household Status	Up to \$3,000 deduction = \$3,000 benefit ; favorable rates	Yes	No
Child Tax Credit	Up to \$2,000 credit (\$1,400 nonrefundable)	Yes	Yes, with a signed Form 8332
Earned Income Credit	1 Child \$3,737 2 Children \$5,572 3+ Children \$6,269	Yes	No

Dependency Rules in Divorce

Custodial vs. Non-Custodial Parent – IRC § 152(e)(4).

- ▶ **Custodial:** “The parent with whom the child resides for the greater number of nights during the calendar year.” 26 C.F.R. § 1.152-4(d).
 - ▶ If equal # of nights, then the parent with the higher Adjusted Gross Income is the Custodial parent. 26 C.F.R. § 1.152-4(d)(4).
- ▶ For the Non-Custodial parent to receive the tax benefits, the Custodial parent must **sign** a [Form 8332](#).
- ▶ The Non-Custodial parent must **attach** the Form 8332 to their tax return every year.

Common Issues in Custody Settlements

1. Granting 50/50 physical custody
2. Using imprecise language
3. Alternating tax years for claiming children
4. Form 8332 Disputes
5. Splitting children between a Custodial and Non-Custodial parent
6. Mismatch between the Order and Reality

Common Issues in Custody Settlements

Granting 50/50 physical custody

- ▶ The IRS relies on an identified Custodial parent. On audit, the IRS looks for evidence demonstrating who lived with the child for the majority of the year.
- ▶ In a 50/50 (or even a 51/49) physical custody split, the taxpayer is often unable to provide this documentation.
- ▶ If audits result in denial of the credits, taxpayers may be banned from the EITC and CTC for 2 years. IRC § 32(k).
 - ▶ Taxpayers may also be disinclined to claim benefits to which they are entitled after a bad experience with the IRS.

Common Issues in Custody Settlements

Using imprecise language

- ▶ Craft the divorce decree so that the client will understand their responsibilities.
 - ▶ E.g.: “Father may claim Child A as a dependent in all even years.”
- ▶ If Father is the Non-Custodial parent, he needs the Custodial parent’s consent, in order to do so.
- ▶ If Father is the Custodial parent, he will need to execute a Form 8332 for all odd years.
- ▶ Further, the Custodial parent may still claim the EITC and Head of Household status.
 - ▶ Causes confusion if Noncustodial parent discovered Custodial parent “claimed” dependent for permissible reasons.

Common Issues in Custody Settlements

Using imprecise language

- ▶ Improvement: “Father may claim Child A as a dependent in all even years. Mother must execute a Form 8332 for each even year releasing her Child Tax Credit. Father understands, under applicable tax law, that he may not claim the Earned Income Credit or Head of Household status on behalf of Child A.”

6. Husband and Wife will have the joint legal care, charge and custody of the one (1) minor child of the parties, namely, [REDACTED] age 6 years. Wife and Husband will have shared physical custody, the parties shall share the holidays pursuant to the Indiana Parenting Time Guideline with Wife designated as the "custodial parent" for the sole purpose of determining the division of the holidays. As an exception to the Indiana Parenting Time

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Guideline, the parties specifically agree that Wife will have parenting time each Halloween. Husband will have the minor child on Christmas Eve each year until 10:00 p.m. when the child is returned to Mother. The child will be with Mother on Christmas Day until 3:00 p.m. at which time Father will have the child through at least December 26, 2012.

8. The parties will file a joint income tax return for the calendar year 2011 and split any refund/debt equally. Commencing in the calendar year 2013 and each odd year thereafter, Husband shall claim the minor child as an income tax exemption. Commencing in the calendar year 2012 and each even year thereafter, Wife shall claim the minor child as an income tax exemption.

What does this provision mean to the layperson?

Common Issues in Custody Settlements

Alternating Years for Claiming Children:

- ▶ Client must understand their responsibilities and rights under tax law.
- ▶ To claim a child for any purpose, Non-Custodial parents must attach a signed Form 8332 to their tax return.
- ▶ Custodial parents may choose to sign Form 8332 for each year, or once for all future years.
- ▶ **REMEMBER:** Non-Custodial parents cannot claim the EITC or Head of Household status based on the children subject to the custody agreement.

Common Issues in Custody Settlements

Form 8332 Disputes:

- ▶ If a Custodial parent refuses to sign a Form 8332, the Non-Custodial parent has **no remedy** in tax law. They must file their return without claiming the children.
- ▶ The Custodial parent has violated the terms of the court's judgment, and the Non-Custodial parent must seek an injunction or other remedy.
- ▶ The Non-Custodial parent may amend the return, with a valid Form 8332. However, under recently-issued regulations, the Custodial parent must also amend their return for that year.

Common Issues in Custody Settlements

Splitting children between a Custodial and Non-Custodial parent

- ▶ Non-Custodial parents may also be under the **mistaken beliefs** ...
 - ▶ That they **do not need cooperation** from the Custodial parent to claim the child, given the language in the decree.
 - ▶ That they may claim their assigned children for ALL purposes.

[REDACTED] (Mother) shall have the right to claim the minor children [REDACTED] as dependent(s) for Federal and State income tax purposes each year beginning in 2012.

[REDACTED] (Father) shall have the right to claim the minor children [REDACTED] and [REDACTED] as dependent(s) for Federal and State income tax purposes each year beginning in 2012.

The Court bases its decision on the following:

Each parent's percentage of the costs of supporting the child.

Common Issues in Custody Settlements

Basing a Dependency Decision on Support, rather than Residence

- ▶ In 2005, Congress passed the Working Families Taxpayer Relief Act, which changed the focus of claiming children from **support** to **residence**.
- ▶ Some decrees appear to still base their decisions upon the relevant support given to each child.

██████████ (Mother) shall have the right to claim the minor children ██████████
██████████ as dependent(s) for Federal and State income tax purposes each year beginning in 2012.

██████████ (Father) shall have the right to claim the minor children ██████████
██████████ and ██████████ as dependent(s) for Federal and State income tax
purposes each year beginning in 2012.

The Court bases its decision on the following:

Each parent's percentage of the costs of supporting the child.

Common Issues in Custody Settlements

Mismatch between the Order and Reality

- ▶ The Order may specify the Custodial/Non-Custodial parent, but the parents' actual living situation may differ.
 - ▶ In this situation, it is the conduct that controls the Custodial/Non-Custodial definition; NOT the Order.
 - ▶ Client Story: A taxpayer was held in contempt of court and imprisoned for failure to execute the Form 8332. But she was the Non-Custodial parent, and so did not have the ability to sign a Form 8332.

Common Issues in Custody Settlements

New Issues from Tax Reform

- ▶ Tax Preparer/Taxpayer confusion in the effect of Form 8332
 - ▶ \$0 dependency exemption → No tax benefit → Don't need to sign a Form 8332.
- ▶ Increased benefit of Child Tax Credit
 - ▶ Overall net positive for non-custodial parents (especially those who are higher earners).
- ▶ Confusion over \$500 Dependency Credit
 - ▶ NOT in addition to other benefits.
 - ▶ Largely relevant only to children older than 16.
- ▶ Children with ITINs not eligible for the Child Tax Credit

Recommendations for Custody Settlements

1. Craft your settlements to specify the conduct the parents need to follow
 - ▶ If one party needs to execute a Form 8332, specify this.
 - ▶ If one party is not entitled to the Earned Income Credit or HOH status because of their Non-Custodial status, specify this as well.
2. Understand and advise your clients on the various tax benefits at issue
 - ▶ Understanding the value of the benefits can inform you in comparing these benefits to other items in a settlement, such as child support, property settlement, and maintenance/alimony.

Recommendations for Custody Settlements

3. Clearly specify a Custodial Parent for tax purposes
 - ▶ Specifically state that someone will have custody of the child for more than $\frac{1}{2}$ of the calendar year.
4. If signing a Form 8332, have the Custodial Parent sign this for future years after concluding custody negotiations
 - ▶ Removes concern of leverage by Custodial Parent
 - ▶ Lessens future interactions between parents, if the relationship is tense.



Property Issues for Divorce

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12 CFR § 1024.31

- ▶ Successor in Interest:
 - ▶ Person to whom an ownership interest in a property securing a mortgage loan subject to this subpart is transferred from a borrower, providing that the transfer is
 - ▶ (4) ...resulting from a decree of dissolution of marriage, legal separation, agreement or other incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property

Language

- ▶ Must clearly transfer ownership and not be conditional on some other issue
- ▶ Be sure to include language that requires a transfer to be made