Children and Taxes: De-Mystifying Five Key Tax Issues Impacting Divorcing Parents

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When counseling clients regarding the various issues that arise in the context of a separation and divorce, child-related tax considerations are often overlooked or addressed only briefly after all other substantive terms are resolved. Understandably, issues of custody, support and the division of property take priority, and tax considerations, which may be complex, case-specific and outside the realm of the particular attorney's expertise, are left on the back burner. The end result is that clients may not receive sufficient information or advice regarding child-related tax issues. While it may still be necessary to advise clients to consult their tax advisor, domestic relations attorneys should have a working knowledge of common child-related tax issues. Understanding the following five child-related exemptions, credits and deductions is critical to mitigate the risk of conflict and confusion come tax season.

Head of Household

The head of household tax filing status can place a parent in a significantly better tax bracket than filing as a single taxpayer or married filing separately. In order to file as the head of household, a party must satisfy three criteria:

1. The taxpayer must be unmarried on December 31 of the relevant tax year *or* have lived separately from his/her spouse for at least the last 6 months of the tax year. To live separately from his/her spouse for this purpose means living in separate households and not living separately under the same roof.

2. The taxpayer must pay more than half the cost to maintain the house for the relevant tax year. This includes payment of property taxes, mortgage interest, rent, utilities, home repairs, insurance and groceries. It does not include paying down the principal balance on the mortgage, improvements to the property or replacement of fixtures and appliances.

3. The taxpayer must have one or more *qualifying* persons who reside with him/her for more than half the year, calculated by the number of nights spent in one household. A qualifying person may be a child or other family member whom the taxpayer could claim as a dependent. Such persons may qualify even if released to the other parent for purposes of claiming the dependency exemption, addressed below.

In consideration of these factors, separating spouses must be aware that continuing to live under the same roof, even if separated for purposes of obtaining a divorce, may prevent one spouse or the other from filing as the head of household. Parties must also be cognizant of both the custodial schedule and the source of funds used to maintain the household, as each of these factors play a critical part in determining one's tax status.

Dependency Exemption

The dependency exemption is a deduction allowed in the computation of taxable income for a person who qualifies as the taxpayer's dependent. Absent an agreement or order to the contrary, a child's custodial parent is entitled to take the dependency exemption, assuming that said parent contributed over half of the child's support during the applicable tax year. The custodial parent is the parent with whom the child resides for the greater number of nights during the calendar year. If a child resides with each parent for an equal number of nights, the parent with the higher adjusted gross income for the calendar year is, for tax purposes, the custodial parent. Accordingly, in the case of a shared 50-50 custodial schedule, the lower-earning parent may find it important to include in any agreement an express provision requiring the parties to alternate the year in which each is entitled to take the dependency exemption.

IRS regulations specifically allow a noncustodial parent to claim the exemption for a dependent child *if* the custodial parent waives the right to take the exemption by attaching to his/her tax return a written declaration from the custodial parent stating that he/she will not claim the child as a dependent for that taxable year. Separation agreements should refer specifically to the custodial parent's obligation to complete form 8332.

The amount of the dependency exemption is adjusted each year for inflation. For tax year 2015, the exemption amount is $4,000 per qualifying child. The exemption phases out when the taxpayer reaches a certain income level. For tax year 2015, the exemption begins to phase out at an adjusted gross income (AGI) of $309,900 for married couples filing jointly ($258,250 for single filers) and completely phases out at an AGI of $432,400 for married couples filing jointly ($380,750 for single filers). If one parent's income exceeds the amount at which the benefit of the exemption is phased out, it should be taken into consideration when allocating the dependency exemption.

Child and Dependent Care Credit

The Child and Dependent Care Credit (CDCC) is a percentage of the amount of work-related expenses paid to a care provider for the care of the taxpayer's dependent. The CDCC is available only to the custodial parent and cannot be allocated or adjusted by agreement or court order. As with the dependency exemption, if a child resides with each parent for an equal number of nights, the parent with the higher adjusted gross income for the calendar year is, for tax purposes, the custodial parent.

The percentage of the credit depends on the taxpayer's adjusted gross income. Dependent care benefits (which may be excluded from income) include: (i) amounts a taxpayer's employer pays directly to the taxpayer or his/her care provider; (ii) the fair market value of care in a daycare facility provided by an employer and (iii) pre-tax contributions to a flexible spending account. The CDCC is limited to the smallest of: (i) the total amount of dependent care benefits received by the taxpayer; (ii) the taxpayer's earned income; (iii) the taxpayer's spouse's earned income; (iv) $5,000 or (v) $2,500 if married filing separately.

To qualify, the taxpayer must satisfy the following:

1. Such amounts must be paid for a child age 12 or younger *when the care was provided*. The credit is adjusted by day and can be awarded for only a portion of the year in which the child was 12 or younger.
2. The care must be work-related, but can be incurred in an effort to seek employment. In particular, the credit does *not* apply to school tuition (except preschool), summer school or tutoring programs, but *does* apply to day camps.
3. The taxpayer must have *earned* income, which does not include spousal and child support, unemployment compensation, interest, dividends, pensions, annuities or social security benefits.
4. Childcare cannot be paid to the taxpayer's spouse, to anyone whom the taxpayer can claim as a dependent or to anyone 19 or younger (whose age is determined as of December 31).
5. The CDCC cannot be taken if filing married filing separately unless the taxpayer would otherwise satisfy the criteria to file as the head of household, addressed above.

Child Tax Credit

Similarly, the Child Tax Credit is an offset against tax liability and another benefit for taxpayers who are eligible to claim the dependency exemption. The Child Tax Credit gives the taxpayer up to $1,000 credit per qualifying child who is under the age of 17 at the end of the tax year. The Child Tax Credit cannot be split from the dependency exemption. In other words, the parent entitled to claim the dependency exemption is the only parent who qualifies for the child tax credit. This cannot be changed by agreement of the parties or court order. The benefit of the Child Tax Credit phases out at $110,000 for joint filers, $75,000 for single filers and head of household and $55,000 for those filing married filing separately.

Higher Education Tax Credits

Finally, for parents of college-aged children, the American Opportunity Tax Credit (AOTC) and Lifetime Learning Credit (LLC) could add up to substantial tax benefits. The AOTC is a credit for qualified education expenses paid for an eligible student for the first four years of higher education, up to a maximum annual credit of $2,500 per eligible student. The LLC is a $2,000 (per tax return) credit for qualified tuition and related expenses for an eligible student, with no limit on the number of years that the credit can be claimed. In order for a parent to claim either credit, that parent also must be entitled to claim the dependency exemption. Both the AOTC and the LLC phase out at certain income levels.

Conclusion

While easy to overlook, child-related tax issues may be of considerable financial consequence to one or both parties in a divorce. Attorneys should address these issues with their clients and tax advisors *before* the ink on any settlement agreement is dry. ❖