DEPENDENT CHILD DEDUCTIONS AND

CHILD CARE CREDIT OR EXEMPTION

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1. INTRODUCTION

This chapter deals with questions concerning the availability of the child dependency exemption. An exemption of $2,150 (1991) and $2,300 (estimated 1992) is allowed in each tax year for the individual who qualifies as a dependent of the taxpayer. Adopted children and stepchildren qualify equally with natural children to be so claimed. While a couple is married and filing jointly, it suffices if the requisite relationship toward a child exists as to either of the marital partners; when filing separately, however, the relationship must be with that spouse who claims the child as a dependent. In the context of a separation or divorce, the regulations provide: "The relationship of affinity once existing will not terminate by divorce..."

By virtue of the 1984 Act, custodial parents are allocated the dependency exemption (1984 Act §423(a). This benefit can be relinquished to the noncustodial spouses, but only by written declaration. Such a declaration might be employed, for example, in order to provide the deduction to a noncustodial spouse in a higher marginal tax bracket and thus save taxes over all. Through a negotiated interspousal settlement, the custodial spouse would be expected to share in the revenue dollars thereby saved. This would be appropriate as compensation for the custodial spouse's loss of the right to claim the dependency exemption. These changes in the area of dependent child exemptions will primarily benefit divorced or separated mothers, who are typically the custodial spouse.

2. GENERAL REQUIREMENTS FOR CLAIMING DEPENDENT CHILD

The general requirements of §§151(c) and 152, which must be met in any case, are outlined below.

Gross Income of Dependent. Excluding exempt income, the gross income of any would-be dependent child of the taxpayer must generally be less than the exemption amount ($2,150 (1991) and $2,300 (estimated 1992) unless the child is under the age of 19 at conclusion of the calendar year in which the taxpayer's claimed dependency exemption began, or the child is a full-time student at an educational institution. The full-time student requirement can be met if during each of five calendar months within a year, the individual is "a full-time student at an educational organization described in section 170(b)(1)(A)(ii)" or "pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of [such] educational organization."

Tax Return Filed by Dependent Child. Any dependent child who is married must not file a joint return with his or her spouse, unless merely to obtain a refund.

Over Half Support. The dependent generally must receive over one-half of his or her total support from the taxpayer claiming the exemption. This requirement is the one most often rendered inapplicable by separation or divorce, in which case it will suffice if more than one-half of the child's support is supplied by his or her parents either individually or

collectively. Support that emanates from the new spouse of a remarried parent is treated as received from the parent for these purposes.

All sources of support must be taken into account. The dependent's own contributions to his or her support, for example, are included -- regardless of whether the dependent's contributions are from taxable or exempt sources. Any amounts of scholarship assistance are not included in the base of support, however, by virtue of §152(d); thus, the requirement of supplying over half the support of the child is more easily met in respect of the taxpayer's child or stepchild who is a student scholarship recipient.

3. SUPPORT -- DEFINITION AND ESTIMATION

Since all claims of dependency exemption involve the support concept, it is helpful to develop a working definition of that term. As a general proposition in absence of any codified definition, support is quite inclusive, encompassing far more than the common law duty of a parent to supply necessities.

Support can take many forms, including payments of expenses of the child and providing in-kind benefits. For example, a parent who paid child support in weekly installments pursuant to a court order was credited with additional payments for sweaters, a birthday gift, coat, cash and entertainment costs. Expenses of providing singing, dancing and dramatic lessons were likewise considered as support, despite the fact that these items were not obligatory.

Lodging supplied to a child is included in support, without question, but it often presents a valuation problem. As provided in the regulations, the amount of an item of support, when it is in the form of property or lodging, is its fair market value. The court reviews not only the size of the house and its price or value, but also its features of relevance to the child: "wooded lot," "a livingroom with fireplace," "a full basement with fireplace," "a small front porch, a sundeck and a patio in the back," "a play area near the fireplace in the basement where [the child] and her friends gathered during the winter months for dancing, marshmallow roasts, and the like," "a music room...[in] which to practice playing the piano and singing for her and her friends to rehearse their musical and theatrical activities," and she "had use of the entire house for entertaining friends." From all this, the court estimated the fair rental value of the lodging provided the child by her mother to be more than twice the value contended by the father -- who sought to show his own contributions were "over half" the total support.

The child must actually receive the amounts, or enjoy the benefits furnished in kind, for them to be counted. The costs of the parent's travel to visit his child do not constitute support. Even where the child is traveling to visit a parent, such expenses have been excluded from support; this type of expense is perceived to be not so much for the child as for personal benefit of the parent. Where the transportation includes the child and is undertaken for the purposes of taking the child to meals or entertainment, for example, then travel costs are included in support.

Moving expenses also have been considered as support, to the extent allocable to the children.

There is a statutory exception from support provide by §152(d) -- "Special Support Test in Case of Students" -- whereby "scholarships for study at an educational organization" are not taken into account in determining whether more than half of the child's support was furnished by the parent seeking a dependency exemption. With regard to nonscholarship support provided by institutions, however, the statutory language is not directly applicable. Those institutional-source payments or benefits will therefore most likely be included within support.

Another statutory exception from the support definition is granted by §151(c) with regard to certain income of handicapped dependents, which could of course include a child. The compensation earned by a permanently and totally disabled individual for performing services at a "sheltered workshop" is disregarded for purposes of applying any of the support tests to determine dependency under §§151 and 152.

4. RECORDS AND BURDENS OF PROOF

Demonstrating "Over Half" the Total Support Amount

In claiming a child dependency exemption, the taxpayer must rely on §152 which entail the need for similar records.

First, anyone who claims the dependency exemption under §152(a) must be able to show that he or she personally furnished over one-half of the dependent's support.

Either one of the divorced or separated parents may claim their children as dependents under §152(e) only if the support supplied by one or both of the parents constitutes more than half of the total support amount from all sources, although any support contributions from the new spouse of a remarried parent are considered as coming from the parent.

In order for either spouse to claim a dependent child exemption under §152(e), for example, the divorced or separated parents should be able to "prove not only their own expenditures in support of each child, but also that those amounts exceeded one-half of the total support provided." While this burden need not involve conclusive proof of the exact or precise total amount expended for children's support, the Tax Court has ruled that parents "must provide . . . convincing evidence that the amount they provided exceeded one-half of that support." Some records and other evidence must therefore be available from which an approximation can be made of the total amount of support provided for the children from all sources.

A record of general family expenses can provide proof of the total support amount. An allocable portion of such general costs, which do not include monies spent specifically on the children alone, are accepted as child support. Thus, household expense records were a basis for the successful claim of a dependency exemption.

In cases where the parents are divorced or separated, the taxpayer who claims an exemption for a dependent child should not have any difficulty with the burden of proving support, by virtue of §152(e). Provided it can be shown that more than half of the child's support came from the combined expenditures of both parents (and new spouse of any remarried parent), there is no need for the custodial parent to prove any personal contribution amounts, although these obviously would have been included in the sum of parental support as well as the total support from all sources.

5. ASCERTAINING WHO SUPPLIED SUPPORT

Source of support issues in the context of separation or divorce are now mooted by §152(e).

In any instance of pre-1985 separation or divorce instrument designating the noncustodial parent as entitled to claim a dependent child exemption, the designee parent need only be able to prove that he or she provided $600 or more of the child's support. Given the modest level of support required in such a case, it is not expected that significant issues will arise over which parent is the source of payments.

Role of §71(c)

A payment which is includible in the recipient's income can be claimed as a child support contribution only by the recipient spouse, rather than by the payor spouse. Section 152(b)(4) provides: "A payment to a [recipient spouse] which is includible in the gross income of the [recipient spouse] under section 71 or 682 shall not be treated as a payment by [the payor spouse] for the support of any dependent." The Internal Revenue Code language precludes the payor from claiming any such payment as a support contribution for the purpose of qualifying under §§151(c) and 152.

There should be no doubt that the converse is equally true. A payor spouse ought to be able to claim contributions to the support of a child in the amount of those payments which are characterized as child support for tax purposes.

The custodial spouse always obtains the dependency exemption claim under §152(e), regardless of which parent furnishes the greater amount of support. If there is a pre-1985 written agreement or decree expressly designating the noncustodial spouse, who is usually the payor, as entitled to claim the child as a dependent under §151(c), the noncustodial spouse need pay no more than $600 of support for the child.

6. ARREARAGES AND PREPAYMENTS

The regulations articulate two limitations on the child support is support rules. First, arrearage payments are treated harshly by being denied as a contribution to support. All child support payments are credited to the

extinguishment of that obligation for the current year; only after the current year's child support has been paid in full will any further payments be credited to any prior year's arrearage. While the payor receives no credit for having made support contributions by virtue of the arrearage payment, all of the current year's child support is regarded as a contribution by the payor spouse.

Second, advance payments are not to be counted as having been made in the year for which they are made.

7. OUTLINE OF SPECIAL RULES CONTROLLING CHILD DEPENDENCY EXEMPTION IN SEPARATION OR DIVORCE

Section 152(e)(1)(A) requires that the parents either (1) be divorced or legally separated by decree of divorce or separate maintenance, (2) be separated under a written separation agreement, or (3) "live apart at all times during the last 6 months of the calendar year." The latter provision, as amended in 1984, obviates the need for any decree or written agreement as a precondition to the application of special §152(e) rules. Both parent's combined periods of custody must account for more than one-half of the year, and their combined contributions to support must make up more than half of the child's support for the year, in order for the statutory tests of §152(e) to be applied.

Under subsection (e), whichever spouse is the custodial parent is entitled to claim the child as a dependent, irrespective of whether the noncustodial parent furnished nearly all of the child's support. Custody that is awarded by decree or controlled by agreement can be thought of as legal custody, which is in contrast to physical custody. A determination by reference to physical custody will have to be made and will control whenever legal custody is split (i.e., to be shared by each of the parents), or when neither a decree nor an agreement establishes who has custody, or if the validity or continuing effect of a decree or agreement that does identify the custodial parent is in question due to proceedings pending at the calendar year's end. Whichever spouse had custody of the child for a greater portion of the year may claim the dependency exemption in such cases. For the year in which a separation or divorce occurs, if both parents had custody until their breakup, the one who has custody of the child for the greater portion of the remainder of the year is entitled to claim the exemption if subsection (e) applies.

The noncustodial parent is entitled to claim dependency of a child in only two cases. Under §152(e)(2), the noncustodial parent may claim a dependent child exemption if the custodial parent signs a written declaration not to claim the child as a dependent for the taxable year, and the noncustodial spouse attaches such declaration to his or her return for the same year. The only other instance in which a noncustodial spouse may obtain the deduction is under the terms of a pre-1985 decree or agreement which designates the noncustodial parent as being entitled to claim the dependency of a child. In cases where there is such pre-1985 decree or agreement designating the noncustodial parent as entitled to an exemption claim, that parent must provide at least $600 of support for the child.

8. CUSTODIAL PARENT IS TREATED AS FURNISHING OVER HALF OF CHILD'S SUPPORT: §152(e)(1)

If the combined support furnished by separated or divorced parents can be demonstrated to constitute over half of the total support expended for a child during the calendar year, and if either or both parents have custody of the child for over half of the year, then §152(e) becomes available to parents who have divorced or legally separated, executed a written separation agreement, or continuously lived apart for the last six months of the calendar year.

The general rule, however, is that "that parent having custody for a greater portion of the calendar year" is entitled to the deduction. Unless that custodial spouse releases her or his right to claim the exemption, or is bound by a pre-1985 decree or agreement which designates the noncustodial spouse as entitled to the exemption, the general rule applies and the custodial spouse is entitled to the deduction.

The custodial parent need not be able to show that any child support was furnished by her or him. It has been pointed out that "the parent with custody of the child for more than one half of the calendar year will be allowed the dependency exemption . . . even though the noncustodial spouse provided 100 percent of the child's support."

It may be more desirable for the noncustodial parent to claim the exemption. This would be so, for example, when the noncustodial parent is in a higher marginal tax bracket than the custodial parent. In any case, the custodial parent may release the exemption to the noncustodial parent. Even then, there will be no need to muster any proof as to which parent furnished what support for the child.

9. NONCUSTODIAL PARENT'S RIGHT TO CLAIM A CHILD DEPENDENCY EXEMPTION UNDER CUSTODIAL PARENT'S RELEASE: §152(e)(2)

Both parents must cumulatively have furnished over half of the child's total support, to claim an exemption.

The Code expressly allows parents to decide between themselves which one of them will be entitled to claim a child as a dependent. The custodial parent may opt to retain the dependency claim -- as may be desirable at least until each year's support payments are received from the noncustodial spouse -- or the custodial parent may release the claim. It is expressly allowed that "[t]he exemption may be released for a single year, for a number of years (for examples, alternate years), or for all future years, as specified in the declaration."

In order to release a dependency claim to the noncustodial parent, subparagraph (A) of §152(e)(2) specifically requires the custodial parent who is entitled to claim a child as dependent to sign a writing which provides that such custodial parent will not claim the child as a dependent for the year. A release is best effected simply by the custodial parent's designing

the noncustodial parent as entitled to the child dependency exemption on the appropriate form from the Internal Revenue Service. If the declaration is not made on the official form, it must at least conform to the substance of such form.

The noncustodial parent is required to attach the custodial parent's declaration to his or her return for the year. The regulations provide that "[i]f the exemption is release for more than one year, the original release must be attached to the return of the noncustodial spouse (i.e., presumably, the return for the year to which the release first relates) and a copy of such release must be attached to his/her return for each succeeding year for which he/she claims the dependency exemption. There is no requirement for the noncustodial parent to have furnished any child support in these instances.

10. NONCUSTODIAL PARENT'S RIGHT TO CLAIM A CHILD DEPENDENCY EXEMPTION BY DESIGNATION UNDER PRE-1985 INSTRUMENT: §152(e)(4)

A pre-1985 court decree or written agreement with the custodial parent, providing that the noncustodial parent is "entitled to any deduction allowable under section 151 for such child," is the alternative basis for a noncustodial parent's claiming of the dependency exemption. Since the agreement in point must antedate January 1, 1985, there is no planning left. However, a question that has arisen in the past, and could again, is: what constitutes a written agreement for these purposes?

A court reporter's transcript of an oral agreement was held to constitute a written agreement. An oral agreement reached during divorce proceedings was disregarded, notwithstanding that the official transcript of proceedings contained the parties' agreement of the oral agreement.

A safe answer to the question of what constitutes a written agreement under §151(e)(4)(A)(i) is: the mutually signed, written separation agreement or settlement entered into between spouses. The agreement will allocate dependent child exemption claims. It may allow for departure from its original designation under certain circumstances which are specifically described, such as economic or tax situation changes.

Pre-1985 contractual and decretal designations of the noncustodial spouse are grandfathered by §152(e)(4)(A). An existing, pre-1985 contract or decree will therefore continue to be controlling of the noncustodial parent's right to claim a dependency exemption -- so long as it is not modified after 1984 to provide expressly that the rule of §152(e)(4) will not apply thereto. Other modifications of a pre-1985 agreement or decree would not appear to disturb its continued efficacy with respect to granting a dependency exemption to the noncustodial parent.

When the terms of a pre-1985 written agreement or decree declare that the noncustodial parent is entitled to claim the dependency exemption, proof of at least $600 of child support by the designated noncustodial parent will determine when finality his or her exclusive right to the deduction.

11. EFFECT OF ARREARAGES WHERE PRE-1985 INSTRUMENT - DESIGNATED NONCUSTODIAL PARENT PAYS AT LEAST $600 OF SUPPORT FOR CHILD

In the context of §152(e)(4)(A)(ii) it must be remembered that the noncustodial parent seeking to claim a dependent child exemption under a pre-1985 instrument need only furnish $600 of support. It has been held that failure to pay the full amount of child support ordered by a divorce decree does not cause either the decree or an incorporated agreement which survived the decree as an independent contract to be void or unavailable to the spouse designated as entitled to claim the dependency exemption.

12. SIGNIFICANCE OF CUSTODIAL PARENT STATUS FOR PURPOSES OF CHILD CARE CREDIT, CHILD MEDICAL EXPENSE DEDUCTION, TAX RETURN FILING STATUS, AND EARNED INCOME CREDIT

The importance of custodial parent status under tax law transcends the dependency exemption area. Even if the custodial parent releases her or his dependency to the noncustodial parent, or is not entitled to claim a dependent child exemption because of a pre-1985 divorce or separation instrument that designates the noncustodial parent as entitled to that deduction, the custodial parent is nonetheless entitled to treat the child as a dependent for many other purposes.

For example, in determining head of household filing status, the test is whether the taxpayer is or would be entitled to a deduction for the child as a dependent under §151. It is therefore immaterial whether a custodial parent has released the dependency claim to the noncustodial spouse, or that a pre-1985 instrument designates the noncustodial spouse as entitled to the dependency claim.

In the same vein, a custodial parent may be eligible to claim an earned income credit as a head of household, notwithstanding that the noncustodial parent has become entitled to claim child dependency by virtue of a release from the custodial parent or a designation made under a pre-1985 instrument. It is also the custodial parent who may be entitled to claim a dependent care credit, again irrespective of the noncustodial parent's possible entitlement to claim a deduction for child dependency under a release or pre-1985 instrument.

Both parents may claim deductions for medical expenses of the child. Insurance premiums paid for medical care coverage, prescription drug expenses, and the costs of transportation essential to medical care are all added to amounts paid for diagnosis, prevention, mitigation, treatment, and cure of any disease, structure, or function of the body when tallying medical care expenses. A parent's own such medical expenses are combined with those incurred by the parent with respect to his or her child. The deductibility of medical expenses is quite limited, however, as only those expenses which exceed 7.5 percent of the taxpayer-parent's adjusted gross income are allowed under §213(a).

13. CREDIT FOR HOUSEHOLD SERVICES AND CHILD CARE EXPENSES NECESSARY FOR GAINFUL EMPLOYMENT: §21

Irrespective of which parent is entitled to claim a child as dependent for exemption purposes, §21 grants a credit to whichever parent has physical custody of the child for a longer period during the calendar year.

A special allowance under §21(e)(5) with reference to parents who are divorced, legally separated by decree, or separated under written agreement, comes into play if the child is in the custody of one or both parents for more than one-half of the calendar year, if more than half of the child's support comes from his parents, and the child is under age 13 (age 15 for tax years prior to 1989) or incapable of caring for himself. Section 21(e)(3) provides that one who is "legally separated from his [or her] spouse under a decree of divorce or separate maintenance shall not be considered as married." This suspends the requirement under §21(e)(2) that married couples who claim the credit must file a joint return. Although §21(e)(3) does not include reference to parents who are separated under a written separation agreement, they too should be outside the joint return filing requirement.

In absence of a decree or written separation agreement, §21(e)(4) applies to grant the same credit to married individuals who are living apart and not members of the same household during the last six months of the taxable year. Here again, the spouse who provides the principal abode of the child is allowed the credit.

Any release of the dependency claim by the custodial parent, or designation of the noncustodial parent under a pre-1985 instrument which entitles the noncustodial parent to a deduction for child dependency, is disregarded; the custodial parent exclusively is entitled to claim a dependent care credit under §21.

Statutory Purpose and Scope

To gain some perspective on §21, one must understand that the expenses of child and household care, as might have to be incurred by any working couple or single parent, are personal in nature and therefore generally nondeductible under §262. No more than $2,400 of employment related expenses can qualify for the credit if there is only one dependent, and no more than $4,800 if there are two or more. Since a 30 percent credit is allowed, the maximum credit amount will be $1,440, but several provisions of §21 may reduce the actual credit below such amounts.

If the parent's adjusted gross income exceeds $10,000, then the credit percentage is to be reduced by one percentage point for each $2,000 (or fraction thereof) over $10,000. However, in no event is the credit reduced below 20 percent. The applicable percentage relative to gross income can be tabulated with the maximum credit amount which is available at each income level:

Maximum Credit Amount

Adjusted Gross Income	Credit Percentage	One Qualifying Individual	Two or More Qualifying Individuals
Up to 10,000	30	$720	$1,440
Over 10,000 to 12,000	29	$698	$1,382
Over 12,000 to 14,000	28	$672	$1,344
Over 14,000 to 16,000	27	$648	$1,296
Over 16,000 to 18,000	26	$624	$1,248
Over 18,000 to 20,000	25	$600	$1,200
Over 20,000 to 22,000	24	$576	$1,152
Over 22,000 to 24,000	23	$552	$1,104
Over 24,000 to 26,000	22	$528	$1,056
Over 26,000 to 28,000	21	$504	$1,008
Over 28,000	20	$480	$ 960