DEPENDENT CHILD DEDUCTIONS AND

CHILD CARE CREDITS AND CHILD TAX CREDITS

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I. INTRODUCTION

This chapter deals with questions concerning the availability of the child dependency exemption. An exemption of $3,200 for 2005 is allowed in each tax year the individual 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 inter-spousal 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.

II. CONSIDERING THE TAX BENEFITS TO PAYOR SPOUSE

(1) Exemption amount. For taxable years beginning in 2008, the personal exemption amount under § 151(d) is $3,500. The exemption amount for taxpayers with adjusted gross income in excess of the maximum phaseout amount is $2,333 for taxable years beginning in 2008.

(2) Phaseout. For taxable years beginning in 2008, the personal exemption amount begins to phase out at, and reaches the maximum phaseout amount after, the following adjusted gross income amounts:

Filing Status	AGI-Beginning Of Phaseout	AGI-Maximum Phaseout
Married Individuals Filing Joint Returns and Surviving Spouses (§ 1(a))	$239,950	$362,450
Heads of Households (§ 1(b))	$199,950	$322,450
Unmarried Individuals (other than Surviving Spouses and Heads of Households)(§ 1(c))	$159,950	$282,450
Married Individuals Filing Separate Returns (§ 1(d))	$119,975	$181,225

III. 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, $3,200 for 2005, 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 § 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.

IV. 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 living room with fireplace," "a full basement with fireplace," "a small front porch, a sun-deck 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 non-scholarship 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.

V. 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 entails 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.

VI. ASCERTAINING WHO SUPPLIED SUPPORT

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. § 152(b)(4) provides: "A payment to a [recipient spouse] which is includible in the gross income of the [recipient spouse] under § 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.

VII. ARREARAGES AND PREPAYMENTS

The regulations articulate two limitations on the child 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.

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

§ 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.

IX. 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.

X. 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 designating 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.

XI. 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 or incapable of caring for himself. § 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."

XII. CHILD TAX CREDITS

The child tax credit allows taxpayers to claim a tax credit of up to $1,000 per qualifying child. This reduces their tax liability, potentially to $0. In order to claim the credit, the taxpayer and child must meet numerous requirements.

When a taxpayer's child tax credit is more than their tax liability, they may be eligible to claim an additional child tax credit as well as the child tax credit. The additional child tax credit is also a tax credit of up to $1,000 per qualifying child. This further reduces their tax liability and can result in a refund. Taxpayers must meet additional requirements to claim this credit.

Child Tax Credit Requirements and Limits

Child Requirements
To qualify, the child must:

- be under age 17 at the end of the tax year
- be a citizen or resident of the United States
- not have provided over half of his/her own support for the tax year
- lived with the taxpayer for more than half of the tax year
- be the taxpayer's:
  - child or a descendant of a child (for example, a grand child)
  - stepchild or adopted child or a descendent of one
  - brother, sister, stepbrother, stepsister, or a descendent of one
  - eligible foster child

Taxpayer Requirements
Taxpayers must provider the name and social security number of each qualifying child on their tax returns.

Credit Limits
The credit depends on the taxpayer's:

- tax liability: the credit cannot be more than the taxpayer's tax liability

- modified adjusted gross income and filing status: the credit may be reduced if the taxpayer's modified adjusted gross income is above a certain amount of their filing status.

Additional Child Tax Credit Requirements and Limits

Child Requirements
To qualify for the additional child tax credit, the child must qualify for the child tax credit.

Taxpayer Requirements
To qualify for the additional child tax credit, taxpayers must:

- meet the requirements previously discussed for the child tax credit
- have a tax liability that is less than their allowable child tax credit
- earn more than $12,050 during the tax year.

Credit Limits
The credit is whichever is lower:

- 15% of the taxpayer's taxable earned income that is over $12,050, or
- The amount of unused child tax credit (caused when tax liability is less than allowed credit)

XIII. DEPENDENT CARE CREDIT

If you paid someone to care for a child under age 13 or a qualifying spouse or dependent so you could work or look for work, you may be able to reduce your tax by claiming the Child and Dependent Care Credit on your federal income tax return. To qualify, your spouse, children age 13 or older, and other dependents must be physically or mentally incapable of self-care.

The credit is a percentage of the amount of work-related child and dependent care expenses you paid to a care provider. The credit can be up to 35 percent of your qualifying expenses, depending upon your income.

For 2008, you may use up to $3,000 of the expenses paid in

a year for one qualifying individual, or $6,000 for two or more qualifying individuals.

These dollar limits must be reduced by the amount of any dependent care benefits provided by your employer that you exclude from your income.

To claim the credit for child and dependent care expenses, you must meet certain conditions including:

- Income - You must have earned income from wages, salaries, tips, other taxable employee compensation, or net earnings from self-employment (one spouse may be considered as having earned income if they were a full-time student or physically or mentally not able to care for himself or herself)
- Payee - The payments for care cannot be paid to someone you can claim as your dependent on your return or to your child who is under age 19, even if he or she is not your dependent
- Filing Status - Your filing status must be single, married filing jointly, head of household, or qualifying widow(er) with a dependent child
- Care - The care must have been provided for one or more qualifying persons
- Home - The qualifying person must have lived with you for more than half of 2007

There are some limitations on the amount of credit you can claim. If you received dependent care benefits from your employer, other rules apply.

For more information on the Child and Dependent Care Credit, see Publication 503, Child and Dependent Care Expenses.