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Tax Implications of Divorce: Treatment of Alimony, Child Support, and the Child's Personal Exemption

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Summary

Alimony payments are deducted from adjusted gross income by the spouse making payments and included in the income of the former spouse receiving payments. Child support payments are viewed as intrafamily transfers of funds that absent divorce would not have given rise to federal income tax consequences and as personal, family expenses are not deductible in determining the taxable income of the spouse making payments or includible in income to the former spouse receiving the payments. The Congress resolved dependency exemption disputes by providing a rule: the custodial parent always receives the child's personal exemption unless the right to claim the child's personal exemption is waived in writing by the custodial parent. This report will be updated as events warrant.

Alimony Payments

It was 4 years after enactment of the income tax before the tax treatment of alimony payments was determined by a 1917 Supreme Court ruling commonly referred to as the *Gould* case. The case law stood from 1917 to 1942 in the absence of a statutory Internal Revenue Code provision. In the period between 1917-1942, alimony was not included in the recipient's income and was not deductible by the payor.

This tax treatment was changed in 1942. Congress was concerned that the payor was fully taxable on all income even though a portion of that income (alimony) was not available from which to pay taxes. It was feared that the combination of alimony and the increased taxes due to high wartime tax rates would not leave taxpayers with sufficient resources with which to meet their tax obligations. Accordingly, the Revenue Act of 1942 taxed alimony to the former spouse receiving payments and permitted an income tax

deduction to the former spouse making the payments.[1, 2] In 1954, the Congress extended this tax treatment to a decree for support (commonly known as separate maintenance payments) where spouses have separated but are not legally divorced.[3]

Under the Tax Reform Act of 1976, the law was changed such that alimony payments are taken from adjusted gross income rather than as an itemized deduction. This change stems from the belief that the allowance of deductibility is more appropriate as an adjustment to income and hence can be claimed by all taxpayers, whether or not they itemize deductions.[4]

Clarifying changes were made with the passage of the Deficit Reduction Act of 1984. Those changes were designed to provide a uniform definition of alimony, since differences in state law created differences in federal tax consequences and, as a result, administrative difficulties for the Internal Revenue Service. The Act defines alimony to distinguish it from property settlements and prevent the deduction of one-time, lump-sum payments.[5] A uniform standard leads to a simpler tax law for administration by the Internal Revenue Service and more equitable tax treatment of the parties to a divorce.

Child Support Payments

In 1942 (and also in 1984), Congress confirmed that payments made for child support are not deductible by the payor or taxable to the payee.[6 7] However, congressional

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[1] Typically the payor of alimony is in a higher tax bracket than the spouse receiving alimony payments; hence, the treatment instituted in 1942 reduces federal tax revenues.

[2] It is likely that the tax treatment of alimony payments evolved partially from the tax system's treatment of the family. A family's earnings are taxed once as an economic unit, typically on a joint return. While the spouses' relationship may be severed by divorce, it does not necessarily follow that the economic relationship has ended. The retention of an economic relationship may lead to the conclusion that the proper taxation of earnings should correspond before and after divorce. In the case of alimony payments, both the shifting of income and its taxability prevent double taxation of the same earnings and, thus, provide a rough tax equivalency after divorce. To do otherwise would be to treat divorced taxpayers as two economic units with income taxable to the spouse who has custody of the child and nondeductible to the payor with a resulting increase in tax burden following divorce. This result would conflict with social policy and generally accepted principles of taxation of the family.

[3] U.S. Congress. House. Committee on Ways and Means. *The Revenue Bill of 1942*. Washington, U.S. Govt. Print. Off., 1942. p. 46 (77th Congress, 2d session. House. Report No. 2333)

[4] U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976 (H.R. 10612, 94th Congress, Public Law 94-455)*. Washington, U.S. Govt. Print. Off., 1976. p. 116-117.

[5] U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Congress; Public Law 98-369)*. Washington, U.S. Govt. Print. Off., 1984. p. 714.

[6] Internal Revenue Code §71(c).

[7] If support payments for both alimony and child support are a requirement of the legal decree,

(continued...)

reports fail to explain the reasons why Congress deemed this tax treatment proper. Some have inferred that the rationale rests with state legal restrictions on support payments. These restrictions designate that child support payments are made for the benefit of the child and not for the benefit of the custodial parent.

The Treasury Department has provided a related explanation for the tax treatment of alimony and child support payments. Treasury finds that the tax treatment of alimony is justified because the payments are neither a personal nor family expense since the family relationship has been terminated by the divorce.[8] However the Treasury finds that divorce does not terminate a child/parent relationship, even if the child and the parent no longer live together. As such, child support remains a personal, family expense.[9]

Some years ago, the American Bar Association House of Delegates approved a resolution in support of legislation which would include all family support payments (child support as well as alimony) in the income of the recipient and provide that those amounts be deductible to the payor. In the report on the resolution issued by the Section of Family Law, it stated that the 1984 tax amendments "created a tax disincentive to paying all support, except alimony ... the amendments are at odds with the need to encourage parents to pay their entire family support obligation. . . The principle [sic] purpose of the family support concept is to recognize that although the marriage dissolved, the duty to the 'family' continues. As long as there are children in the custody of a parent, the need for family support is present."[10] [11]

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[7] (...continued)
then payments are first applied as child support payments and than as alimony payments. Thus, any underpayment of support is more likely to consist of a deductible alimony payment rather than a nondeductible child support payment. Payments made under post-1984 instruments that either establish an amount of money or part of the payment as child support are treated as child support for tax purposes and are not deductible. If an amount set out in the instrument relates to the child and is reduced based on a contingency — such as reaching a specified age or income level, dying or marrying, leaving school, or becoming employed — the reduction amount is treated as child support and is not deductible. The Tax Court found that if the divorce instrument designates an allocation to an arrearage between alimony and child support payments, then the instrument's allocation controls the tax treatment of the payments. See Verticelli V. Commissioner, 62 T.C.M. (1991).

[8] The economic relationship of alimony and child support payments are similar and, thus, a similar tax treatment can be derived from the tax system's treatment of the family. Such a change would involve tradeoffs between horizontal equity and simplicity and could be expected to result in lower federal tax revenues. Lower revenues would result since payors of child support usually have higher marginal tax rates (associated with higher earnings) than those receiving such payments. For additional detail, see footnote number 2.

[9] *Outgoing Treasury Letter*. Tax Notes. V. 26, no. 6, February 11, 1985. p. 528.

[10] *ABA Delegates Adopt Resolution to Equalize Child Support, Alimony Treatment*. Daily Tax Report, The Bureau of National Affairs, Inc., Washington, D.C., No. 154, August 11, 1989; p. G.-1.

[11] It has been suggested alternatively that the payor of child support should qualify for head of household tax status. See Divorced Father Complains of Unfair Taxation. *Tax Notes*, September 7, 1998. p. 1131.

Personal Exemption of Child

Prior to the passage of the Deficit Reduction Act of 1984, the custodial parent was entitled to the child's dependency exemption if the parent provided more than half of the child's support. An exception to this rule provided the noncustodial parent with the dependency exemption if either (1) there was a written agreement or decree allocating the personal exemption to the noncustodial parent and the noncustodial parent provided at least $600 per calendar year for the child's support or (2) the noncustodial parent provided a minimum of $1,200 per calendar year for child support and the custodial parent did not establish greater support spending.[12] Special rules applied to multiple-support agreements where no one person provided more than the requisite one-half of the child's support.

Under a provision enacted as part of the Deficit Reduction Act of 1984, the personal exemption for a child typically belongs to the custodial parent.[13] [14] There are three exceptions to this rule: a multiple-support agreement which provides the dependency exemption to a person other than the custodial parent; the custodial parent's release of the exemption to his/her former spouse;[15] [16] or a pre-1985 divorce decree or separation agreement providing the exemption to the noncustodial parent (who must provide at least $600 for the child's support).[17]

The prior rules allocating the dependency exemption between parents often were subjective and presented difficult problems of verification and substantiation. As a result, the Internal Revenue Service was compelled to intercede when both parents claimed the

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[12] Prior to the change in 1984, some held the view that the availability of the child's personal exemption provided a partial offset against nondeductible child support payments. This offset worked only up to the amount of the personal exemption and, thus, tended to provide benefits for only modest amounts of support payments. The 1984 legislative history does not show a comprehensive examination of all the issues at the time of this change in tax treatment.

[13] Either or both parents may itemize payments for a child's medical expenses regardless of who is entitled to claim the child's personal exemption.

[14] The rule is no longer applicable when the child reaches the age of majority and parental control ceases under state law.

[15] The agreement must be in writing. Oral agreements may be recanted at a later date. See No Dependency Exemptions for Noncustodial Parent; Statutory Exceptions Don't Apply. *Tax Notes*, November 2, 1998. p. 582.

[16] The Internal Revenue Service provides a form which allows the custodial parent to release the claim to the child's personal exemption. The release may be made for only the current year or for any number of future years. See Form 8332 entitled *Release of Claim to Exemption for Child of Divorced or Separated Parents*. The form is attached to the noncustodial parent's tax return each year that the child's personal exemption is claimed. A written declaration including the same information as required by Form 8332 may be used in lieu of the form. Typically the custodial parent provides an annual release so as to ensure receipt of child support payments.

[17] The courts have found that the father was entitled to his two children's personal exemption since the pre-1985 divorce decree entitled him to the exemptions. His former wife insisted that it was inequitable since the children's father had failed to pay all the medical expenses of the children as required by their modified divorce decree with the result of the mother having paid more than half of the children's support. See *Bonnie A. Broughton v. Commissioner*, T.C. Memo. 1998-409.

dependency exemption based on providing support for the child. The costs borne by the government for resolution of the disputes were large when compared to the tax revenue at stake. The Congress provided certainty by allowing the custodial spouse the child's personal exemption unless the custodial spouse waives his or her right to claim the exemption.[18] As a result, the Internal Revenue Service is no longer involved in dependency disputes between parents.[19]

As an interesting aside, it is not always advantageous for a high-income taxpayer to claim the child's personal exemption. Under a provision of the Omnibus Budget Reconciliation Act of 1990 the personal exemption amount is reduced or eliminated for very high income taxpayers. The phase-out range depends on the taxpayer's filing status and is annually adjusted for inflation. The personal exemption is reduced by 2% for each $2,500 (or fraction thereof) by which the taxpayer's adjusted gross income exceeds the threshold level. For 2002 the threshold levels are: $206,000 for joint returns, $137,300 for single returns, and $171,650 for head of household returns. Thus, for higher income taxpayers the ability to claim a child's dependency exemption may have little or no tax consequences.

Interactions With Other Code Provisions

A former spouse qualifies to use the lower (than single) tax rates associated with head of household filing status if he/she provides the principal residence (exceeding more than one-half the year) for a son, stepson, daughter, or stepdaughter of the taxpayer, or a descendant of a son or daughter of the taxpayer. However, if the relative is married at the close of the taxable year then the head of household filing status is available only if the former spouse is entitled to claim a dependency exemption for the relative under Code §151 or, but for an agreement to release the dependency exemption to the noncustodial parent under Code §152(e)(4), would have been eligible to claim the dependency

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[18] Kenneth W. Gideon, a former Assistant Secretary of Treasury for Tax Policy (1989-1992) states that in 1984 when this change in law was sought by the Internal Revenue Service it was estimated to eliminate approximately 2,000 docketed cases of disputed exemptions per tax year. He goes on to say that the rule "replaced a perhaps more theoretically correct rule which allocated the exemption to the parent furnishing the most support. But that rule led to repeated and protracted litigation and dispute." Later, he explains that "Successful, practical rules like these ought to have a high value not just to tax practitioners but also to tax legislators and tax thinkers because ultimately they make it easier for all of us to be compliant tax *payers*. Such rules are understandable. They can be applied with a high degree of certainty that the taxpayer's return position and the Internal Revenue Service position on audit will be the same and that there will not be a large economic "spread" between the two, resolvable only by processes of negotiation and even litigation. Resolution by negotiation and litigation, however fairly conducted, must impose real costs: uncertainty, delay, attorneys and accountants fees. Compounding these difficulties is the fact that outcomes in negotiated and litigated cases are not uniform, thus creating a sense of unfairness to participants who perceive that they did not achieve the results obtained by others." See Assessing the Income Tax: Transparency, Simplicity, Fairness. *Tax Notes*, November 23, 1998. p. 999-1,000.

[19] U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984; (H.R. 4170, 98th Congress; Public Law 98-369).* Washington, U.S. Govt. Print. Off., 1984. p. 717-718.

exemption.[20] Such status is unavailable for unrelated persons or in the case of persons covered by multiple-support agreements.[21]

Under the Taxpayer Relief Act of 1997 (P.L. 105-34) an income tax credit was instituted for families with dependent children. The dependent child is defined as the son, daughter, grandson, granddaughter, stepson, stepdaughter or an eligible foster child under the age of 17 at the close of the calendar year. The child credit is phased out for higher income taxpayers. The phaseout range for heads of household begins at a $75,000 adjusted gross income level (with the phaseout range increasing to $110,000 in the case of married couples). The credit phases out by $50 for each $1,000 that the taxpayers income exceeds the phaseout threshold amounts. Under the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, the child credit was increased to $600 for tax years 2001-2003 and will phase-in at higher amounts over an 11-year period. The credit is refundable.[22] The credit is available **only** to the parent entitled to claim the child's personal exemption.[23] The purpose of the credit is to provide a general federal income tax reduction to families with children.[24]

In the case of medical expenses either or both parents may itemize payments made for a child's medical expenses no matter which parent is entitled to claim the child's personal exemption. If there is an obligation to pay the divorced spouse's medical/hospitalization insurance premiums (or future medical expenses), the payments may qualify as alimony and be deductible by the payor. In the case of medical insurance premiums for a policy which covers both the former spouse and the children, then the entire premium will be considered as deductible alimony unless a portion can be identified as "fixed" for the support of the children under Code §71(c).[25]

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[20] McMahon, Martin J., Jr. Tax Aspects of Divorce and Separation. *Family Law Quarterly*, v. 32, Spring 1998: p. 259.

[21] Internal Revenue Code §152(a)(9) and §152(c).

[22] The child credit is refundable to the extent of 10% of the taxpayer's earned income which is in excess of $10,000 for calendar years 2001-2004. This percentage increases to 15% beginning in 2005. The $10,000 amount is indexed for inflation beginning in 2002. Further, for families with three or more children, the credit is refundable by the amount which the taxpayer's Social Security taxes exceed the taxpayer's earned income tax credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,000.

[23] Internal Revenue Code §24(c)(1)(A).

[24] For additional information see CRS Report 97-860, *The Child Tax Credit*, by Gregg Esenwein.

[25] McMahon, Martin J., Jr. Tax Aspects of Divorce and Separation. *Family Law Quarterly*, v.32, Spring 1998: p. 239-240.