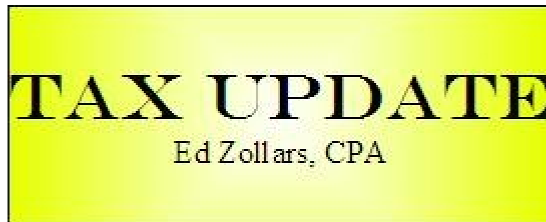

It Depends—IRS Proposes New Divorced Parents Regulations
Podcast for May 7, 2007

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The "Custodial Parent" Rule and How to Waive

The IRS has now released proposed regulations that will deal with a law that was enacted 23 years ago in an attempt to simplify the determination of who gets to claim the dependency exemption between divorced parents. In the interim, the IRS has issued a set of temporary regulations and various instructions that, it seemed, served to confuse matters. A series of cases over the past decade have served to focus attention on the matter, and the IRS has decided now is the time to attempt to deal with certain issues with new regulations.

The new regulations were issued only as proposed regulations, and there was no indication that the regulations could be relied upon in the interim. So to the extend that these regulations lead to a different result that we would have had under prior guidance, apparently the prior guidance will continue to govern the situation until the year after the year in which these regulations are made final—so for most taxpayers, the earliest they could apply, if they go final, would be 2008.

But, that said, they likely do serve to give a clue as to the how the IRS believes taxpayers

should resolve issues that are not totally clear under the current temporary regulations.

The Law

The law the IRS is looking to clarify is found in §152(e), which reads as follows:

> (e) Special rule for divorced parents, etc.
>
> (1) In general
>
> Notwithstanding subsection (c)(1)(B), (c)(4), or (d)(1)(C), if--
>
> (A) a child receives over one-half of the child's support during the calendar year from the child's parents--
>
> (i) who are divorced or legally separated under a decree of divorce or separate maintenance,
>
> (ii) who are separated under a written separation agreement, or
>
> (iii) who live apart at all times during the last 6 months of the calendar year, and--
>
> (B) such child is in the custody of 1 or both of the child's parents for more than one-half of the calendar year, such child shall be treated as being the qualifying child or qualifying relative of the noncustodial parent for a calendar year if the requirements described in paragraph (2) or (3) are met.

The above establishes those parents that are covered by this provision, which means meeting one of the three categories listed (including living apart the final six months of the year) and set the reference to the conditions a noncustodial parent will need to make in order to claim the exemption for the child for the year.

Those conditions are outlined as we continue through the provision. The second condition can be ignored for the most part—the passage of time has rendered most pre-1985 decrees moot on the issue of claiming an exemption for a child. So for the vast majority of clients, the real test is found below:

> (2) Exception where custodial parent releases claim to exemption for the year
>
> For purposes of paragraph (1), the requirements described in this paragraph are met with respect to any calendar year if--
>
> (A) the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year, and
>
> (B) the noncustodial parent attaches such written declaration to the noncustodial parent's return for the taxable year beginning during such calendar year.

This exception gives two conditions that the noncustodial parent must meet in order to

claim the dependency exemption (which otherwise would be available to the custodial parent). Both conditions must be met—the custodial parent must sign a declaration that complies with the IRS regulations and the noncustodial parent must attach the statement to his/her return.

The nature of that statement has created a number of controversies in Tax Court—controversies that were not helped by IRS instructions issued in years just following the inclusion of this provision in the law that might be charitably described as "unclear" if not just simply misleading to both taxpayers and tax professionals that did not look back at the underlying law.

Those instructions implied that , a copy of the divorce decree would suffice to document the waiver of the exemption. However, the regulations indicated clearly what had to be in the document submitted and, in reality, most court orders fell far short of these requirements. While the instructions did have the caveat that the decree had to provide the information that otherwise would have been provided. The temporary regulations specified that:

> **Q-3** How may the exemption for a dependent child be claimed by a noncustodial parent?
>
> **A-3** A noncustodial parent may claim the exemption for a dependent child only if the noncustodial parent attaches to his/her income tax return for the year of the exemption a written declaration from the custodial parent stating that he/she will not claim the child as a dependent for the taxable year beginning in such calendar year. The written declaration may be made on a form to be provided by the Service for this purpose. *Once the Service has released the form, any declaration made other than on the official form shall conform to the substance of such form.* (Temporary Regulation §1.152-4T(Q3))

The Tax Court in a number of cases interpreted that sentence to meant that the document had to list the name and social number of the custodial parent, that parent's signature, the name of the child in question and an unconditional grant of the exemption. As well, the notice should indicate if the exemption was released for only the current year and also included some or all future years. Most court issued divorced decrees failed to have a number of these items.

Since the purpose of the 1984 law change was to keep the Tax Court from having to get its hands dirty dealing with divorce instruments, the Tax Court applied the regulations strictly—noncustodial parents in virtually every case would lose the exemption unless they had a signed Form 8332 or some other document that followed the form exactly.

The law also provides a mechanical test for who is the "custodial parent" and again attempts to create a mechanical test for the Tax Court rather than forcing the court to decipher divorce decrees and the impact of specific state laws:

> (4) Custodial parent and noncustodial parent

> For purposes of this subsection--
>
> (A) Custodial parent
>
> The term "custodial parent" means the parent having custody for the greater portion of the calendar year.
>
> (B) Noncustodial parent
>
> The term "noncustodial parent" means the parent who is not the custodial parent.

Divorced spouses are not necessarily the most cooperative in many cases. As well, quite often there may not a qualified tax adviser working with each spouse—so we end up with a number of cases where a noncustodial spouse and the custodial spouse both end up claiming the exemption. In some of those cases, the noncustodial parent has not obtained the appropriate waiver, either because it was never asked for or because the custodial spouse is withholding his/her signature.

Especially in the latter cases, the noncustodial parents have attempted to argue that they should be entitled the exemption—but in almost all cases, the Court has turned a deaf ear to the argument, indicating that the test is a purely mechanical one and refusing to attempt to impose what might be argued to be a "fair" solution. Rather, the Tax Court has indicated that the noncustodial spouse needed to pursue a remedy in state court to deal with the issue.

Original Temporary Regulations

In 1984, shortly after this provision first made its way into the law, the IRS issued temporary regulations—regulations that continue to apply to this day. Those regulations outlined the following guidance:

> Q-1 Which parent may claim the dependency exemption in the case of a child of divorced or separated parents?
>
> A-1 Provided the parents together would have been entitled to the dependency exemption had they been married and filing a joint return, the parent having custody of a child for the greater portion of the year (the custodial parent) will generally be entitled to the dependency exemption. This rule applies to parents not living together during the last 6 months of the calendar year, as well as those divorced or separated under a separation agreement.
>
> Q-2 Are there any exceptions to the general rule in A-1?
>
> A-2 Yes, there are three exceptions. The general rule does not apply (i) if a multiple support agreement is in effect (see section 152(c)), (ii) if a decree or agreement executed prior to January 1, 1985 provides that the custodial parent has agreed to release his or her claim to the dependency exemption to the noncustodial parent and the noncustodial parent provides at least $600 of support to the child

> (see section 152(e)(4)), or (iii) if the custodial parent relinquishes the exemption in the manner described in A-3.
>
> Q-3 How may the exemption for a dependent child be claimed by a noncustodial parent?
>
> A-3 A noncustodial parent may claim the exemption for a dependent child only if the noncustodial parent attaches to his/her income tax return for the year of the exemption a written declaration from the custodial parent stating that he/she will not claim the child as a dependent for the taxable year beginning in such calendar year. The written declaration may be made on a form to be provided by the Service for this purpose. Once the Service has released the form, any declaration made other than on the official form shall conform to the substance of such form.
>
> Q-4 For what period may a custodial parent release to the noncustodial parent a claim to the exemption for a dependent child?
>
> A-4 The exemption may be released for a single year, for a number of specified years (for example, alternate years), or for all future years, as specified in the declaration. If the exemption is released for more than one year, the original release must be attached to the return of the noncustodial spouse and a copy of such release must be attached to his/her return for each succeeding taxable year for which he/she claims the dependency exemption.
>
> Q-5 May only the custodial parent claim a deduction under section 213(d) for medical expenses paid by the parent or an income exclusion under section 105(b) for medical expenses paid by an employer for a dependent child?
>
> A-5 No. Under the new rules, if a child receives over half of his support during the calendar year from his parents who are divorced or legally separated under a decree of divorce or separate maintenance, or who are separated under a written separation agreement, that child will be treated as a dependent of both parents for purposes of sections 105(b) and 213(d). Thus, a parent can deduct medical expenses paid by that parent for a child even though a dependency exemption for the child is claimed by the other parent. The special rule of sections 105(b) and 213(d) does not apply where over half of the support of a child is treated as having been received from a person under the provisions of section 152(c) (relating to multiple support agreements).
>
> Q-6 When does section 152(e), as amended by the Tax Reform Act of 1984, become effective?
>
> A-6 Section 152(e), as amended, is effective with respect to dependency exemptions for taxable years beginning after December 31, 1984.

The temporary regulations cleared up a few points that weren't necessarily totally clear in the Code. First, Q&A 1 makes it clear that the IRS was going to look for a "count the days" test in order to determine who was the "custodial parent" under these rules. This

allowed the IRS to deal with the case where parents are granted "joint" custody or some other arrangements—the IRS does not end up interpreting the decree, but rather just ends up looking for where the child was the largest number of days.

The temporary regulations also made it clear that the IRS form was going to define what had to be provided on a document purporting to allow the noncustodial parent to claim the exemption for the child. This portion of the regulation generated the most significant amount of litigation, largely due to the reading that many taxpayers (and more than a few preparers) gave to the IRS instructions on the question of the use of a divorce decree in lieu of Form 8332

The regulation notes that a custodial parent can waive the right to claim the exemption for all future years. However the temporary regulation provides for no means for a custodial parent to change his/her mind later and rescind that permission due to a change in circumstances. In fact, the instructions to Form 8332 caution the custodial parent against waiving the right to claim the exemptions for all future years—strongly implying that under the current regulations there is no way to "undo" such a waiver.

The IRS has been content to rely on these temporary regulations for over 20 years—but now they have decided the time has come to update the regulations.

Proposed Regulations

The IRS issued proposed regulations that would clarify the treatment in certain cases as well as grant some new rights and procedures.

However, it's important to note that these regulations were issued only as proposed regulations—so, right now, they are merely ideas about how, maybe, the regulations should be changed. But to the extent these regulations are in conflict with the temporary regulations, the temporary regulations will control until such time as final regulations come into effect. These proposed regulations indicate that the effective date would be the first taxable year of a taxpayer beginning after the regulations go final—so for most taxpayers, the earliest they would apply would be 2008 if they go final before December 31, 2007.

However, to the extent these proposed regulations clarify issues that may not be clear under current law, they would offer an arguably "reasonable" interpretation of the law—so they may still be of some use currently.

In the preamble to the proposed regulations, the IRS emphasizes that federal law, and not state law, is what is at issue here. As the preamble notes:

> Sections 151 and 152, not state law, determine whether a divorced or separated parent may claim an exemption for a child for Federal income tax purposes. A state court order or decree does not operate to allocate the federal exemption between parents.

The point that a state court order by itself is irrelevant for purposes of applying Sections 151 and 152 will continue to be emphasized in the proposed regulations.

One key point is a slightly revised definition of a "custodial"parent under these regulations. The proposed regulations provide the following new language for determining a custodial parent in Proposed Regulation §1.152-4(c)(1):

> (c) Custodial parent -- (1) In general. The custodial parent is the parent with whom the child resides for a greater number of nights during the calendar year, and the noncustodial parent is the parent who is not the custodial parent.

Note the subtle change here—we test the time period for counting custody by counting nights under this rule. The temporary regulations merely stated the greater part of the year, but now we are told to count the number of nights a child resides with each parent to determine the custodial parent.

Thus, if A has the child with him all day, but the child returns to B that night, B gets to count that "day" as her day for purposes of testing custody even if the child was actually in the physical custody of A for a far greater portion of the 24 hour period.

The regulations also deal with time periods when a child is away from the parent in Proposed Regulation §1.152-4(c)(2):

> (2) Absences. For purposes of this paragraph (c), when a child resides with neither parent for a night, the child is treated as residing with the parent with whom the child would have resided for the night but for the absence. However, if the child would have resided with neither parent for a night during an absence (for example, because a court awarded custody of the child to a third party for the period of absence), the child is treated as residing with neither parent for the night of the absence.

Thus, if Child C spends the night at a friend's house during a period when the child otherwise would be staying with B, B gets to count that night. However, if a court awards custody to another party for a period, neither parent will get to count that night. Note that if this custody is assigned to a third party for more than half the year, then §152(e) does not apply—§152(e)(1)(B) requires that the child be in the custody of the parents for over half of the year.

Again, these changes serve to clarify the way we determine who had custody the greater period of the year. Since this reading is not at odds with the current temporary

> (3) Special rule for equal number of nights. If a child is in the custody of one or both parents for more than one-half of the calendar year and the child resides with each parent for an equal number of nights during the calendar year, the parent with the higher adjusted gross income for the calendar year is treated as the custodial parent.

If the parents "tie" under the counting rules, the regulations look to the overriding tiebreaker rules found at IRC §152(c)(4)(B)(ii) that grant the exemption to the parent with the higher adjusted gross income.

It is also important to remember that in establishing the right to claim the child as the custodial parent, the general rule is that the burden of proof is on the taxpayer—so the IRS could take the position that neither parent had established status as the custodial parent if neither produced records or they disagreed on where the child had stayed various nights. Your client needs to understand that they bear the burden to show they are entitled to the exemption.

The proposed regulations go on in Proposed Regulation §1.152-4(d) to outline the requirements for the custodial parent to grant the right to claim the exemption to the noncustodial parent.

> (d) Written declaration -- (1) Form of declaration -- (i) In general. The written declaration under paragraph (b)(3)(i) of this section must constitute the custodial parent's unconditional release of the parent's claim to the child as a dependent for the year or years for which the declaration is effective. A declaration is unconditional if it does not expressly condition the custodial parent's release of the right to claim the child as a dependent on the noncustodial parent's meeting of an obligation such as the payment of support. A written declaration must name the noncustodial parent to whom the exemption is released. A written declaration must specify the year or years for which it is effective. A written declaration that does not specify a year or years has no effect. A written declaration that specifies all future years is treated as specifying the first taxable year after the taxable year of execution and all subsequent taxable years. A court order or decree may not serve as the written declaration.

The above provision outlines a number of basic requirements for the written declaration to be effective in granting the noncustodial parent the right to claim the child. Note that there must be no conditions imposed on the release of the exemption by the written document—the imposition of a condition of any sort will render the document ineffective for transferring the exemption to the noncustodial parent.

The document must also specify the year or years for which it is to be effective. If it fails to specify these items, the document will not be effective to transfer the right to claim the exemption. If the declaration specifies that it applies to all future years it will not apply to the current year, but rather to the first year following the year in which it is executed. That is literally a proper reading, but it does provide a trap for the unwary who try to draft a document that transfers the right.

As well, note that the IRS specifically indicates that a court order or decree will not be effective to transfer the exemption. While it is unlikely that such a document would meet the tests imposed in any event (and that has been pointed out a number of times even under the current temporary regulation in the case law), apparently even in the unlikely event that you had a court order or decree that met all the requirements it would still be ineffective in transferring the exemption.

However, note that in Example 5 the IRS does accept a written separation agreement that

conforms to all the requirements in the regulation as a valid release for these purposes. But in Example 8 the IRS emphasizes that even if the divorce decree unconditionally requires a parent to execute the Form 8332, if the parent does not execute that form the noncustodial parent cannot claim the dependent for that year.

> (ii) Form designated by IRS. A written declaration may be made on a form designated by the IRS (currently Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents). A written declaration not on the form designated by the IRS must conform to the substance of that form.

This portion of the proposed regulations basically mimics what we find in the temporary regulations, repeating the requirement that any alternative declaration has to conform to the substance of the IRS form. As a practical matter, it seems risky to attempt to make use of an alternate form, since to the extent any form varies from the Form 8332 (and having a variance would seem the main reason to use a customized form) it runs the risk of not being deemed acceptable—a significant risk for the noncustodial parent.

> (2) Attachment to return. A noncustodial parent must attach the original written declaration to the parent's return for the taxable year in which the child is claimed as a dependent. If a release of a claim to a child is for more than one year, the noncustodial parent must attach the original written declaration to the parent's return for the first taxable year for which the release is effective. The noncustodial parent must attach a copy of the written declaration to the parent's return for each subsequent taxable year for which the noncustodial parent claims the child as a dependent.

The requirement to attach the form to each year's return is again nothing new—the same requirement is found in the temporary regulations.

> (3) Revocation of written declaration -- (i) In general. A written declaration described in paragraph (d)(1) of this section may be revoked by providing written notice of the revocation to the other parent. The revocation may be effective no earlier than the taxable year that begins in the first calendar year after the calendar year in which the parent revoking the written declaration provides the written notice.

The ability to revoke a declaration that granted a release of the exemption for future years is something new in the current regulations. As noted earlier, the current form seems to imply that, under the temporary regulations, a parent is not able to revoke the declaration later.

However, since it appears this is contrary to what is allowed under the temporary regulations (or at least they do not seem to provide for a revocation), use of this provision may have to be delayed until these regulations go final. However, since it could not be effective until the year *after* the year in which written notice is given, it is still possible this option might be open for 2008.

Note, though, that a client that attempts to make use of this provision may face consequences in state court—while a state court cannot determine who gets the federal exemption, it can impose consequences on individuals who take actions to defeat the intent of the court and agreements. So a client may find him/herself in a bit of trouble outside the tax law if the custodial parent unilaterally revokes permission.

> (ii) Form of revocation. The revocation may be made on a form designated by the IRS whether or not the written declaration was made on a form designated by the IRS. A revocation not on that form must conform to the substance of the form. The revocation must specify the year or years for which the revocation is effective. A revocation that does not specify a year or years has no effect. A revocation that specifies all future years is treated as specifying the first taxable year after the taxable year the revocation is executed and all subsequent taxable years.

The proposed regulation, like the original temporary regulation, suggests the IRS will design and issue a form for this purpose. And, as with the 8332, it's likely that taxpayers should make use of the IRS form or risk the IRS finding that the revocation was ineffective.

> (iii) Attachment to return. The custodial parent must attach the original revocation to the parent's return for the taxable year for which the custodial parent claims a child as a dependent. If a revocation is for more than one year, the custodial parent must attach the original revocation to the parent's return for the first taxable year for which the revocation is effective and a copy of the revocation to the parent's return for each subsequent taxable year for which the custodial parent claims the child as a dependent. The custodial parent must keep a copy of the revocation and evidence of delivery of written notice of the revocation to the noncustodial parent.

Note that now it is the *custodial* parent who has to attach the document to every future return. Also, note that the custodial parent is going to need evidence of delivery—and the regulations don't give additional guidance on what will qualify as evidence of such delivery.

The regulations also clarify that the child will be the child of both parents for certain purposes under the IRC:

> (e) Coordination with other sections. A child who is treated as the qualifying child or qualifying relative of the noncustodial parent under section 152(e) and this section is treated as a dependent of both parents for purposes of sections 105(b), 132(h)(2)(B), and 213(d)(5).

That means the child will be treated as the child of both parents for the purpose of employer paid medical care under §105, for no additional cost services and qualified employee discounts under §132 and medical expenses under §213.

The proposed regulation at §1.152-4(b)(2) has added a clarification that the rules do apply to parents who have never been married, so long as they meet "not lived together for the

last six months of the year" requirement.