CALIFORNIA LAWYERS ASSOCIATION
TAXATION SECTION
WASHINGTON D.C. DELEGATION

AMENDMENT OF INTERNAL CODE SECTION 152(e) IN ORDER TO BETTER REFLECT TAXPAYER REALITY AND ENSURE TAXPAYER SAFTEY

This proposal was prepared by James Creech, a member of the California Lawyers Association Taxation Section.[1][2]

Contact Person: James Creech
Law Offices of James Creech
1921 Page St
San Francisco CA 94117
Phone: (312) 469-0883
jcreech@creechtaxlaw.com

[1]The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the California Lawyers Association or of the Los Angeles County Bar Association.
[2]Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this paper.

EXECUTIVE SUMMARY

Internal Revenue Code Section 152 is a lynchpin code section for many individual taxpayers. Section 152 defines who is a dependent for federal tax purposes. Under current law who is a dependent, and who may claim the dependent, is determinative of who may claim certain deductions and credits.

Section 152(e) creates a narrow set of circumstances where a non custodial parent may claim a dependent that lives with the other parent. In order for the non custodial parent to claim a dependent, the custodial parent must sign a written declaration unconditionally stating that the custodial parent will not claim the dependent for a taxable year. It must name the parent who will claim the dependent and the tax year or years for which the release is valid. The non custodial parent must attach the statement from the custodial spouse to their return. The regulations specifically state that a court order or separation agreement may not serve as a release for tax purposes.

These stringent regulations do not reflect taxpayer reality. The majority of separations or divorces are done either pro-se or by family law attorneys with no familiarity with the tax code. Taxpayers and their counsel are frequently unaware of Section 152's requirements. Taxpayers may not understand that the IRS is not bound by a family law court. However in many instances, if the parties come to an agreement it is likely that the only place the tax consequences are addressed is in the divorce decree. A taxpayer who relies solely upon the decree they will not meet the requirements of 152(e) even if they acted in good faith.

If the non custodial spouse is disallowed the dependency the applicable credits may go unclaimed and deductions may go unused. This harms both parties because there is less money for the family and renders the underlying economic agreement between the parties useless.

A solution to this problem is to modify the regulations to allow a court order or signed agreement between the parties to satisfy the written document requirement of Section 152(e). This would allow the understanding between the parties to have economic effect, provide predictability, and better reflect the taxpayers understanding of the tax consequences of the separation.

DISCUSSION

I. INTRODUCTION

One of the most important factors of for determining the correct amount of tax due for many individual taxpayers is how many dependents they may claim. Internal Revenue Code Section 152 defines who is dependent. Section 152 contains a number of requirements designed to make sure that the taxpayer claiming the dependent is in fact the one supporting the dependent. Section 152(c) contains a residency test which requires a qualifying child to live with the taxpayer for more than one half of the taxable year.

IRC Section 152(e) allows for a limited exception to the residency test under 152(c). A non custodial parent may claim a dependent who lives with the custodial parent if the custodial parent signs a written declaration stating they will not claim the dependent for a particular tax year or years.[3] During the creation of 152(e), Congress delegated the power to determine what qualifies a valid written declaration to the Secretary of the Treasury as part of the regulation writing process.

When Treasury drafted the regulations they created as system that focused more upon the ease of administration rather than the needs of the taxpayers. This focus on ease of administration is misguided because it creates barriers that the average taxpayer who wishes to take advantage of Section 152(e) may not be able to comply even with a good faith effort to do so.

Beyond an inability to comply, the language of the Treasury Regulations may mean that taxpayers are forced to remain in contact with their former partner despite physical or mental abuse. The regulations also create long term uncertainty for taxpayers. Since claiming dependency can change year to year, and the custodial spouse has unlimited power to revoke their consent, the non custodial parent is always at risk of unilateral revocation of

---

[3] Section 152(e)(2) states: 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

their ability to claim the dependent for even if the revocation is done for non tax related reasons. It is time for Congress, and the Department of the Treasury, to reevaluate these requirements in light of who the intended beneficiaries are and their ability to comply without .

II. LEGISLATIVE HISTORY

The current version of Section 152(e) was enacted as part of the Tax Reform Act of 1984. Prior to the 1984 amendment, Section 152(e) existed as a three part factual test. The first two prongs were dollar indexed support tests. The third prong was based upon the parties agreement with regards to who should claim the dependent. Each of the three tests was a factual test that required significant efforts on behalf of the IRS to make a determination. As a result of the vagueness of Section 152's language, most of IRS's time and energy was spent determining what was the dollar amount spent providing "support" under the first two prongs, given that what constituted "support" was not clearly defined for purposes of Section152(e).

Given the fact specific nature of Section 152(e) audits, the code section was targeted for reform in order to reduce IRS workload. The House Ways and Means Committee report cited a desire to make determinations of who properly claimed a defendant easier on the Service, while still allowing for dependency shifting between taxpayers.[4] The new Section 152(e) dropped both of the means tests and focused solely on the agreement between the parties. Under the new Section 152(e), if the parties entered into a written agreement stating that the non custodial spouse was unconditionally entitled to claim the dependent, they were legally allowed to do so. The new Section 152 enabled the IRS to perform a cursory check of the non custodial spouse's return in order to determine if the requirements have been met. If the agreement was revoked, or failed the requirement of Section 152(e), then the custodial spouse who met the requirements of Section 152(c) would be entitled to claim the dependent.

---

[4]The Committee Report, in the section entitled "Reasons for Change," stated: The present rules governing the allocations of the dependency exemption are often subjective and present difficult problems of proof and substantiation. The Internal Revenue Service becomes involved in many disputes between parents who both claim the dependency exemption based on providing support over the applicable thresholds. The cost to the parties and the Government to resolve these disputes is relatively high and the Government generally has little tax revenue at stake in the outcome. The committee wishes to provide more certainty by allowing the custodial spouse the exemption unless that spouse waives his or her right to claim the exemption. Thus, dependency disputes between parents will be resolved without the involvement of the Internal Revenue Service.

As the committee report noted it was hoped that this would allow the Internal Revenue Service to avoid being entangled in dependency disputes. It was anticipated that if there was a breach of the parties custody agreement the recourse for the wronged non custodial spouse would be a civil claim for tax loss. There was no language included about what would happen if neither party claimed a dependent due to an error by the non custodial spouse.

III. CURRENT STATE OF 152(E)

Today Section 152(e) carries over unchanged from the 1984 legislation. It remains a modifier of Section 152(c) which contains the general rule for who may claim a qualifying child. Section 152(c) requires that a qualifying child must meet a five part test:

1. A relationship test with the taxpayer claiming the dependent.
2. A principle place of residence test. The dependent must live with the taxpayer claiming the dependent for more than one half of the tax year.
3. Age requirements.
4. A support test. The dependent must not have provided more than one half of their own support.
5. The dependent must not have filed a joint return for the claimed tax year.

Absent Section 152(e) there is no way for a non custodial parent to claim a child whom they support but do not live with because they would fail the residency test under Section 152(c)(1)(B). Section 152(e) serves two important purposes. It allows parents to match tax benefits to support and give the parents control over the dependency allocation allows for a larger overall pool of post tax dollars for the support of the family.

IV. PRACTICAL LIMITATIONS OF 152(E)

The current version Section 152(e) makes sense when viewed from the perspective a department trying to conserve administrative resources. From that perspective, it creates a strict bright line test that allows the IRS to

quickly and efficiently determine the proper claimant of the available credits.

However the assumptions that the IRS makes in order to justify this detached review are unrealistic. For the current rules to be implemented fairly the IRS expects rational well advised taxpayers. The regulations expect that divorcing parents will analyze their earnings, and estimate their future year tax liabilities. They then form a child care plan. They assign the dependency of the minor child to the working non-custodial spouse. Both parties agree that having the higher earner claim the dependency, and any credits that follow, generates a larger tax savings. In consideration of this assignment, the support agreement allocates a percentage of the savings to the custodial spouse. After this analysis, and having been fully informed by their respective competent family law attorneys and CPA's, they execute a valid IRS Form 8332 for current and future tax years. The CPA then attaches the valid form to the return each and every year for which the parties have agreed to make the non custodial allocation. If audited the IRS simply checks the form is fully executed and is not required to intervene in the taxpayer's personal affairs. The entire operation is clinical, relatively quick to administer, and uniform.

In practice this application of 152(e) makes assumptions that in many cases are not correct. These assumptions include:

1. Taxpayers are rational even at times of intense personal stress such as the dissolution of a marriage or relationship involving a child. They do not harbor animosity towards a former partner for unrelated bad acts for years to come.

2. Taxpayers are generally informed about the tax law.

3. Uninformed taxpayers will realize they are uninformed. They will seek to learn about the tax laws. The law as written is accessible to a lay-person. Anyone who wishes to learn can fully understand and comply with the law.

4. If represented by a family law attorney, the attorney will understand the tax consequences of their area of the law. They fully inform the client/taxpayer and faithfully fully complete the relevant documents.

5. A family court judge signs off on the agreement which finalizes the matter at the state level. Both parties are informed and understand that a state level judge has no authority to bind a federal agency such as IRS. The parties understand they have an ongoing duty to make sure that they follow the agreement to the letter for all subsequent years.

6. The agreement will be provided to a competent tax return preparer. The tax return preparer will provide long term return preparation. The return preparer will keep the document safe and remember to attach it for each and every tax year that the parties agreed the non custodial spouse is entitled to claim the dependents.

7. If circumstances change, or if the form is lost, the taxpayers will contact the other parent who will willingly sign a new form. If incomes change the parties will adjust the dependency exemption to maximize the tax benefits.

8. The taxpayers will act in good faith under their agreement. The custodial spouse will never improperly revoke their consent.

What is far more likely is that a couple with a child separates. The divorce decree, or separation, is a messy and hard fought document. Ultimately as part of the compromise the parents agree that each parent gets to claim the child every other year for "taxes". The compromise is included in the decree and approved by a family law judge. Neither party, nor their attorneys, are aware of the requirements under Treasury Regulation 1.152-4(e) and may or may not know of Form 8332. After the decree is finalized the attorneys spend time reviewing the document with their clients on other more important issues such as who gets the child for holidays, how much the support obligation payments are, etc. They then wish their clients well, and the taxpayers are left to use their best judgement on how to comply with their agreement.

The next time the taxpayers think about the issue is following tax season. If they have any questions there is no professional to ask because both parents use free to file software to prepare their returns. They simply check the boxes the software shows them in order to claim the dependent if it is their year to claim the child. For the most part the parties abide by the document however after time passes they either become less diligent about fol-

lowing the order, or circumstance change and the custodial spouse intentionally disregards the order in order to save on their tax liability or to maximize their refund.

V. RECENT ADMINISTRATIVE CHANGES ARE GOING TO MAGNIFY 152(E)'S SHORTCOMINGS

For most of the tax years since 1984, Section 152(e) has been a relatively minor code section. Claiming a dependent had implications as to filing status and some credits and taxpayers had other options to lower their tax bill. Furthermore an innocent mistake was likely to go unchallenged. However during the past half decade tax administration has become more effective. The result of these changes is that the IRS is going to uncover and audit an increasing number of returns that assign a dependent to a non-custodial spouse.

During the last several years the IRS has become skilled at matching returns. Part of the driver for this change is the need to combat systemic, sophisticated identity theft run by overseas organized crime. These organized crime groups are often able to reproduce a return almost identically to a real return, even down to the correct AGI and the dependent's social security numbers.

In this arms race with the criminals, the IRS has developed technology that will automatically flag returns that appear to be inappropriately using social security number. If both parents of a dependent use the child's social security number on their return, it is more and more likely that the IRS will flag the return. This will lead to an increase number of non custodial parent's claiming dependents being selected for audit which will magnify the harsh realities of the Treasury Regs if they were properly entitled to claim the dependent but did not attach the required forms.

VI. SUGGESTIONS FOR MODIFICATION OF 152(E)

The Department of Treasury and Congress should make changes to IRC Section 152(e) and the Regulations under 1.152-4 to make them more user friendly for the average taxpayer. The easiest way to do this is to look at the tax code as it was prior to 1984. Under the pre 1984 laws state courts, and binding agreements voluntarily entered into by taxpayers, were determinative as to who could claim a dependent.

A written statement for purposes of Section 152(e) should be modified to include a court decree that is binding on the parties, or an agreement signed by the parties and clear as to what years it applied to. By allowing a broader range of what documents qualify it is more likely that the wishes of the taxpayers will be reflected during an determination. This would also allow for a more objective test that does not require significant time or effort on behalf of the government. These changes are needed because the current set of laws often fail to take into what the taxpayers expect to happen or reflect what they believe they are entitled to.

Broadening the scope of what counts as a written document would not unduly shift the burden to the IRS. The taxpayer would still have to show that they were providing the required support, the child met the age requirements, and they are a qualifying relative. The only thing it would do is provide the taxpayer another option to show that they were legally entitled to claim the dependent by using non tax documents.

A. The Regulations Should Reflect Taxpayer Reality

When crafting regulations involving domestic matters, such the dependency rules under Section 152, the law should take into account who are the impacted taxpayers. The regulations and the steps needed to comply with the regulations should be written for average Americans. This would require regulations written for high school graduate level of understanding. According to the US Census Bureau 88% of Americans have a high school diploma or GED.[5] Only 33% of Americans have a college degree and 12% have an advanced degree. The tax laws should treat 100% of Americans as possibly having a child. The current law is complexly to comply with. Form 8332 is a short form with roughly half a page to fill out. However there are another page and a half of detailed instructions in small print. For a lay person with limited education, the instructions are not easily understandable. The more complex the instructions the more distrust is created when signing an official form, especially when it is an adversarial party asking you to do so.

In addition to education, the regulations should take into account taxpayer circumstances. Frequently taxpayers trying to understand and comply with Form 8332 are under extreme stress. Getting divorced or sepa-

[5] 2015 Study

rating from the parent of your child is one of the most stressful set of circumstances the average taxpayer will go through in their lifetimes. The taxpayer may go through the loss of a home, the loss of their day to day routine, the loss of friends and family, and financial stress. They may have health problems, have lost their job, or be self medicating with drugs or alcohol. These stress factors are likely to increase their anxiety, decrease their trust in other people or agencies, and make them prone to bad decisions.

Generally, one of the ways that taxpayers minimize the harm from being uninformed and emotional is hiring a lawyer. However looking at the demographics of the United States and the income levels by educational group it is clear that this is not an option for many taxpayers. In 2016 the average high school graduate (or equivalency) earned $43,000 per household. Roughly 50% of Americans have a high school degree but not a four year college degree. For Americans making $43,000 per year hiring a lawyer may not be an option due to the cost. A 2005 study found that the majority of divorce cases had at least one pro-se litigant. In almost 30% of cases neither party had an attorney. Given that a reasonable estimate for attorney fees in a divorce is somewhere between $15,000-$30,000 it is unsurprising that a household making $3500 per month would opt to spend their income on necessities such as rent or food instead of an attorney. What this means for tax policy is that the regulations should not automatically assume that the taxpayers will have counsel that can alert them to Section 152 issues.

Access to counsel does not necessarily provide a taxpayer with tax advice. Many non tax attorneys have no competency in tax. A sizable number of family law want no competency in tax and may go out of their way not to give substantive tax advice. It is an unrealistic assumption that a family law attorney will know of, and advise their clients as to, the details of a non custodial spouse claiming the Child Care Credit under IRC Section 21. One only has to look at the volume of litigation surrounding alimony, and how poorly some of the agreements are drafted in order to claim a well understood tax provision, to appreciate the likely transference of those types claims due to poorly drafted agreements lack of informed clients to issues surrounding dependency.

B. The Service Should Prioritize Taxpayer Agreements Over Ease of Administration

The tax code should work for taxpayers instead of the IRS. If taxpayers come to an arms length arrangement their affairs, and that araignment is legal, drafting regulations that respect those agreements is part of good tax administration. Treasury should not create "gotcha" hurdles for taxpayers that cannot be easily understood by the impacted taxpayers. This is especially true if those "gotchas" were enacted solely for the benefit of the Service.

Respecting arms length taxpayer agreements is a common theme throughout the tax code. Usually they are in more complicated areas of the code such as transfer pricing, the taxation of legal settlements, or sales of property between related parties. However the principles behind the IRS respecting the agreement of the taxpayers should not be abandoned simple because the applicable Code Section is 152 not Section 482. In the family law area taxpayer agreements are usually at arms length. They are often between taxpayers who are angry with each other. The taxpayers who enter the agreement frequently have representation and the settlement is often the product of much back and forth. As a result Treasury should take care to make sure that the economic effect of those agreements are not superseded by ease of administration.

C. The Service Should Prioritize Finality Over Annual Solutions

While one of the fundamentals of tax is that every tax year stands on its own, Section 152 requires a different approach. Using a year to year standard brings a risk of:

1. Of unwanted or inappropriate contact between the parents based upon the pretext of needing a new release.

2. The custodial parent can use the threat of withholding consent or revoking a prior consent based upon non tax related matters/demands

In these cases where there is inappropriate contact, or wrongful withholding/revocation of consent, the civil remedies available to the parents are too expensive for the parties to get proper resolution given the financial

resources of the parties and the amounts at issue. As a result the IRS is in a better position to act as an intermediary to resolve these issues because willful non compliance by the parties may impact future tax compliance and undermine the integrity of the tax system.

Unwanted contact is a serious risk for the custodial parent who ended the relationship because of either physical or mental abuse. Having a child with an abusive partner may allow for that abuse to continue for decades. In a tax context a couple that ends their relationship close to the birth of a child may have up to 24 years where one spouse is entitled to a deduction or a credit. If the parents agree to allocate a dependent via Section 152(e) that agreement may require contact for each of those tax years. For an angry and abusive ex-spouse each contact is another opportunity to continue the abuse. If the regulations under Treasury Reg. §1.152-4 were modified to allow the non custodial spouse to simply attach a previously executed, non revocable, binding agreement as opposed to a year to year authorization this would be one fewer reason to initiate contact.

Conversely, Section 152(e) gives the custodial spouse ongoing leverage over the non custodial spouse. The regulations allow for the custodial spouse to revoke consent for any reason. It is not a stretch to envision this revocation to be use punitively for actions that upset the custodial spouse.

For example H and W are divorced. The divorce decree requires the spouses to alternate years in which they claim their two minor children on their taxes. W is the custodial spouse. She works as a teacher earning $45,000 per year with a take home pay of $3,000 per month. H is in construction and pays minimal support because he makes slightly less income. In December of 2016, H states that he is taking the two children to DisneyWorld for Christmas with his girlfriend (whom he was seeing prior to the end of the marriage). W is understandably upset and decides to get back at him by revoking her consent for 152(e) for 2017. If each dependent is worth roughly $2000 per year, she can effectively unilaterally reduce H's income by $4,000 or 10% of his gross income, while increasing her take-home income by 10% because she was mad at H.

In this situation H has no recourse but to file a civil claim against W for breach of contract. H is unlikely to do so because it cost prohibitive for $4,000. Even a small claims case takes resources and time off of work and it may not be worth it, especially if it further fragments H's rela-

tionship with W. For all intents and purposes H may be without recourse despite W's breach of contract.

If H files the return and claims the dependents that the divorce decree says he is entitled to, they will be denied if he is audited. Because of the IRS matching system, he is at increased risk for audit even if he was unaware of the revocation. If selected he will insure stress, potential costs of representation, and possible additional tax liability if the audit is expanded into other areas. From a filing perspective, H may have done nothing wrong but may end up punished none the less. Family law may be an area where two wrongs make a right, but tax administration should not be.

D. Adequate Safeguards Can Be Created To Avoid A Whipsaw

Treasury already has systems in place for other areas of the code where tax meets family law to avoid whipsaws. Those protections could be expanded or modified for Section 152(e) audits. Two options are 1. Congress and Treasury could implement the notification provisions similar to Section 6015 so that the custodial parent was notified when the non custodial parent's dependency claim was audited and what the result was of the audit. This would allow them to either intervene or amend their return if they did not claim the dependent or 2. Treasury could automate a correspondence audit of the custodial spouse to determine if the dependent was being claimed twice. Keeping both the tax years open for both parties would allow the Service to make sure that only one of the taxpayers claimed the dependent and prevent a whipsaw.

VII. CONCLUSION

Due to changes in the law and the administration of the tax code Section 152(e) is going to become more prevalent in the coming years. Due to the stringent regulations for a non custodial spouse to claim a dependent, more and more of these claims are going to be denied. While these denials are going to be technically correct they will not be equitable. When taxpayers know they paying more than their fair shared due to a technicality this leads to loss of trust in the tax code and less compliance. Congress and the Department of the Treasury have an opportunity to create a fairer tax system by permitting the intent of the parties to govern the tax consequences.