ABA/AICPA/TEI Tax Simplification Recommendations
September 13, 2002
Attachment A: Simplification of Qualifying Child Definitions

Reasons for Change.

The use of different definitions to determine who is a qualifying child for purposes of the dependency exemption, the earned income tax credit ("EITC"), the child credit, the dependent care credit, and head of household filing status (collectively, the "Child Based Benefits") has led to widespread confusion and inadvertent errors as taxpayers have mistakenly believed that if they have a "child" who qualifies for one of the benefits, they are entitled to all of them. For this reason, we support efforts to create a uniform definition of a qualifying child that would apply to all Child Based Benefits, and we unreservedly support these efforts. We further believe that the approach used in the April 2002 released by Treasury ("Treasury Proposal"), which would define a qualifying child according to a three pronged test (based on age, relationship, and residence), and essentially eliminate support as a criterion, is the right one. We also note that in broad scope this approach is consistent with the recommendations of the National Taxpayer Advocate in her 2001 Proposal to the Congress ("NTA Proposal"), with the Joint Committee's 2001 Tax Simplification study ("Joint Committee Recommendations"), and with the Portman Tax simplification bill, H.R. 5166 ("Portman Bill").

Recommended Changes

We support the unified definition approach set forth in the Treasury Proposal and commend Treasury, the NTA, the Joint Committee and Representative Portman for seeking to rationalize this unduly complicated area. The unified definition set forth in the Treasury Proposal is an important stride toward simplification.

While we believe the Treasury Proposal represents an excellent starting point, we offer the following comments which we believe will improve the Treasury Proposal and aid in gaining public acceptance.

Relationship Test

The Treasury Proposal defines a number of lineal familial and adoptive relationships that qualify for child status. The Treasury Proposal then states:

> *If the child is the taxpayer's sibling or stepsibling or a descendant of any such individual, the taxpayer must care for the child as if the child were his or her own child.*

We agree that siblings and stepsiblings and their descendants should be included in the definition of qualifying relationships for the child tax benefits. Today's unconventional households, driven in part by expensive rental housing, often find siblings, nieces and nephews sharing the same living space and residing as part of the same family unit, and in many instances these individuals play an important role in connection with rearing the child.

However, the language of the Treasury Proposal, as quoted above (which appears to copy current law, as amended in H.R. 1836, the Economic Growth and Tax Relief Reconciliation Act of 2001), has included in it a backdoor support test, because "caring for" the child will require a showing of such activities as purchasing food, clothes, school supplies, toys, medical care, entertainment, etc., as well as paying rent for the premises in which the child and the taxpayer reside. Because the Treasury Proposal as a general matter rejects support as a part of the "qualifying child" definition, and because the "care for" requirement is vague and hard to administer (how many weekend outings or birthday gifts are necessary to meet the test?), we recommend that siblings, step siblings and their descendants simply be included in the general description of qualified relationships and that the "care for" language be dropped. We believe that the residence and tiebreaker rules (which give first priority in the case of dual claims to the child's parents) would avoid any abuses of including such relationships as qualified ones.

This approach is consistent with the Joint Committee recommendations and Rep. Portman's bill, both of which include brothers, sisters, stepbrothers, stepsisters, and their descendants as qualifying relationships without additional requirements.

Residence Test

Dependency Exemptions: Tradeability.

Under the Treasury Proposal the dependency exemption, like the other Child-Based Benefits, will be awarded based on a showing of residence rather than support. This is a dramatic shift from existing law. The Treasury Proposal further states that the dependency exemption cannot be released to a non-custodial parent except in the case of grandfathered child support agreements. This non-tradeability feature is also included in the Joint Committee Recommendations and the Portman bill. The NTA's approach is somewhat more liberal: the NTA would allow the non-custodial parent to claim the dependency exemption but only if the custodial parent signs a written release covering the tax year, and the non-custodial parent attaches that release each year to his or her tax return.

We disagree with the non-tradeability feature of dependency exemptions under the Treasury Proposal, and also believe that the NTA recommendation is too restrictive. We believe divorcing couples should continue to be able to bargain over the dependency exemption as part of their settlement, and further believe that the NTA's requirement of a yearly statement of release by the custodial parent is a trap for the unwary. Although we understand that making the dependency exemption tradeable will complicate the Treasury Proposal, we believe elimination of the tradeability feature will add significantly greater complexity to divorce proceedings. Under the Treasury Proposal, non-custodial parents who pay substantial child support, which is nondeductible, would be deprived of any benefit from these expenditures even though their tax-paying ability is clearly affected (and the custodial parent may receive no benefit from claiming the dependency exemption). Of course, if the parties have not voluntarily assigned the dependency exemption between them, we agree that the custodial spouse should be the proper recipient of the benefit.

As an ancillary recommendation, the NTA would permit single or separated non-custodial parents who pay more than nominal child support to claim head-of-household filing status. While we believe this recommendation is worthwhile and should be considered by Treasury, we do not believe it is an adequate remedy for eliminating tradeability. Eligibility for head-of-household filing status has no benefit if the non-custodial parent has remarried, a common occurrence, and is eligible to file a joint return. In this regard, the dependency exemption is an important bargaining chip between divorcing taxpayers, and may well have an impact on a non-custodial spouse's compliance with child support obligations.

We recognize that permitting tradeability will undermine the uniformity of the qualifying child definition. However, we believe the additional complexity burden is warranted because elimination of this flexibility will impose an additional economic burden on families with dependent children who are already financially burdened by divorce. It may also create audit issues where none would exist under current law because the recipient of the dependency deduction was designated under the support agreement.

Shared Physical Custody of the Child

Under the Treasury Proposal, a custodial parent with whom the child resides will receive all the Child Based Benefits. As a result, determining which parent will be considered the custodial parent in shared child custody situations becomes increasingly important. Under current law, in cases where both parents have claimed the EITC with respect to the same child (*i.e.*, inconsistently), or where only one parent claims the EITC but the child does not reside with that parent for the full year, IRS audits require the parents to reconstruct days spent with the child during the year to determine the availability of the EITC and/or who is the proper claimant. In these cases, because parents normally do not keep contemporaneous records of days spent with their children, this can be quite challenging. Moreover, even if the child's visitation history can be determined, the task of determining how to count days can be exceedingly complex. Issues include, for example (1) what constitutes a day, including the day in which the child moves from one parent's household to the other's; (2) how days should be counted where the child is visiting relatives or has playdates or sleepovers at the homes of friends; (3) how days are counted where the child is at school and both parents are working; (4) what happens if both parents spend time with the child on certain days, *e.g.*, shared holidays like Christmas Day, or vacations, or days spent jointly taking the child to camp or school; (5) how days should be counted where the child resides at the taxpayer's house, but the taxpayer is out of town; and so on.

By making all Child Based Benefits, not just the EITC, turn on more than six months residency with the taxpayer, the Treasury Proposal puts added pressure on counting days, and Treasury should provide additional guidance on this subject. We look forward to working with Treasury on such issues.

To reduce disputes, we specifically recommend that Treasury give consideration to providing safe harbors along the following lines: (1) if one parent has been awarded physical custody of the child, the child should be presumed to be a qualifying child as to that parent unless the presumption is rebutted by evidence that the child spent at least 183 days of the year with the noncustodial parent (the "6-month test"); (2) if the parents have been awarded joint physical

custody and the child does not satisfy the 6-month test with respect to one parent, the child should be treated as a qualifying child with respect to the parent who claims the Child Based Benefits, provided the other parent does not also claim the Child Based Benefits; and (3) if the parents have been awarded joint physical custody and the child does not satisfy the 6-month test with respect to one parent, the child should be treated as a qualifying child with respect to the parent that has the higher AGI. We also suggest a clarification that, for this purpose, the income of the parent is determined without regard to the income of a spouse with whom that parent may file a joint return.

These safe harbors should in no event restrict the custodial parent from relinquishing the right to treat the child as a dependent to the other parent, as under current law.

Age Test

The Proposal recommends no change in the age tests for the various Child Based Benefits under existing law, which generally use four different ages for the different benefits: 13, 17, 19 and 24. Although simplification concerns might suggest reducing the number of different ages involved (e.g., using the same age limits for the child credit and the dependency exemption), we recognize that revenue constraints may preclude such streamlining of the qualification thresholds.

Continued Use of the Support and Gross Income Tests in Certain Cases

Although relegated to a significantly reduced role by the Treasury Proposal, the Treasury Proposal acknowledges that the support and gross income tests would continue to be used in order to allow dependency exemptions for adult disabled children and parents, and perhaps also for children of US taxpayers living in Canada and Mexico. We agree with this more limited use of the support and gross income tests.

Unrelated Children as Dependents

The Treasury Proposal states that:

> *As under current law taxpayers would also be able to claim a distantly related or unrelated child as a dependent if the child resides in the taxpayer's home for the full year and meets the current law dependency tests. Further, such children would still not qualify the taxpayer for the child tax credit or the EITC unless placed in the home by a state agency. However, if more than one taxpayer claims a child as a dependent, then the proposed residency-based tests would supercede current law.*

The NTA recommendation on this issue would include as a qualifying relationship any unrelated foster child who is placed in the taxpayer's home by an authorized placement agency provided the taxpayer has been recognized as the child's custodian by an eligible state agency providing benefits such as food stamps, SSI or TANF.

Prior to 2001 the EITC permitted a foster child to be a qualifying child; and the law defined a foster child broadly as anyone who lived in the taxpayer's residence for the entire year and whom the taxpayer cared for as his or her own child. This led to many double claims for the same children. e.g., by live-in boyfriends, boarders, aunts, uncles, or others who were residing in the household, as well as by the child's parent. The EITC tiebreaker rules at that time gave the credit to the taxpayer with the higher AGI. The parent of the child often lost the tie.

In 2001, the law was changed to provide that foster children could still be claimed but the definition of a foster child was narrowed to one placed in the residence by an approved state or other agency. The tiebreaker rule was also changed to give first priority to the child's parent.

The Treasury Proposal continues this narrower definition of foster child for purposes of the EITC, but permits a dependency deduction (based on a support test) for unrelated or distantly related children where there is no double claim, as under current law. We agree with the Treasury's Proposal. While there is merit in the NTA Proposal regarding prior investigations by public agencies providing support, we have some concerns about the administrability of this recommendation.

We also note that the Portman Bill would require a taxpayer to care for a foster child "as the taxpayer's own child" in order for the foster child to qualify under the uniform definition even though the bill would require placement by a state-authorized agency in order for a child to be considered a "foster child." The care requirement is needed when state involvement is not required to classify a child as a "foster child;" however, we do not believe it is required when the category is restricted to state authorized placements. For that reason, we believe the care requirement should be omitted.

Public Benefits

Under current law, the calculation of whether the taxpayer provided more than one half of the child's support for dependency exemption purposes is made taking into account public assistance payments, such as TANF, medicaid, section 8 housing, and food stamps. If these benefits are substantial, and are valued at more than the taxpayer's support contribution, the taxpayer will not be able to claim the dependency exemption.

Unlike the Portman Bill, which would exclude means-tested public assistance from the definition of support, the Treasury Proposal does not specifically address the issue of public assistance payments, presumably because it relegates support to such a reduced role. However, under the Treasury Proposal, as noted above, support will continue to be important in certain cases. We believe that, in such cases, public assistance payments by government agencies should not be taken into account.

First, the public benefits rule is extremely difficult to administer. How these benefits such as medicaid or section 8 housing subsidies (the latter are granted on a sliding income scale) should be valued is very difficult if not impossible. Second, low income taxpayers who spend all of their disposable income on their children simply do not understand a rule which says that they did not support the child for tax purposes.

Household Maintenance Test

The household maintenance test is a secondary support test that under current law applies to the dependent care credit and to head of household filing status. Under this test, the taxpayer must prove that she or he maintained a household where the child resided. This test can be met by showing that the taxpayer paid rent, made mortgage payments, paid for repairs, or otherwise maintained the household.

The Report eliminates this test for the dependent care credit but not for head of household filing status. We recommend that it be eliminated for both. Elimination for both would reduce complexity by avoiding the confusion that would necessarily result from taxpayers believing they are entitled to head-of-household status simply because they have a qualifying child. In addition, we believe head-of-household filing status denotes family status, not a financial test.

Conclusion

We support the Treasury Proposal to adopt a uniform definition of "qualifying child." We believe the following modifications will improve the Treasury Proposal and aid in gaining public acceptance:

* Eliminate the requirement that the taxpayer care for siblings and stepsiblings and their descendants "as the taxpayer's own child;"

* Continue to allow tradeability of the dependancy exemption as under current law;

* Provide guidance on conventions to be used in counting days to determine periods of residency and consider the provision of safe-harbors;

* Continue to use the support test for adult disabled children, parents and perhaps also for children of US taxpayers living in Canada and Mexico;

* In light of the requirement of state authorized placement of foster children, eliminate the requirement that taxpayers care for a foster child "as the taxpayer's own child."

* In situations where the support test continues to be relevant, eliminate the requirement that public assistance payments be taken into account.

* Eliminate the household maintenance test for purposes of qualifying for head-of-household filing status as well as for purposes of the dependant care credit.