VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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STATE LAW V. FEDERAL LAW

Who has priority? When it comes to taxes, that would be federal law. The IRS has very specific rules regarding who is entitled to dependency exemptions. But what happens when the divorce decree specifies something different?

First, let's take a brief look at the IRS rules. IRC 151(c) allows a taxpayer an exemption for his "dependents". The term "dependent" includes a son or daughter of the taxpayer over half of whose support was received from the taxpayer. Sec. 152(a).

However, when a child's parents are divorced, section 152(e)(1) provides a special rule to determine which one of them is entitled to the dependency exemption. That section provides that, if a child received over half of his support from his divorced parents, and such child is in the custody of one or both of his parents for more than one-half of the calendar year, then the parent having custody for a greater portion of the calendar year is entitled to the dependency exemption. The regulations further provide that where the parents have "split" custody, custody "will be deemed to be with the parent who, as between both parents, has physical custody of the child for the greater portion of the calendar year." Sec. 1.152-4(b), Income Tax Regs.

An exception to these rules is provided in section 152(e)(2), which allows the dependency exemption to the noncustodial parent when the custodial parent agrees to release the exemption. In that case, the noncustodial parent must obtain from the custodial parent a written declaration that he or she "will not claim such child as a dependent for any taxable year beginning in such calendar year" and attach the written declaration to his or her return. The IRS has a form for this declaration. That would be Form 8332.

The problem often lies where a party to such an agreement does not follow the direction of the divorce decree. Even when a court order is in place granting the dependency exemption to a noncustodial parent, federal tax law prevails. The exception granting the noncustodial parent the exemption under section 152(e)(2) applies only if "the custodial parent signs a written declaration".

So what happens if Form 8332 is not properly completed and attached to the tax return claiming such an exemption? Not good things. Not only will the noncustodial parent's tax be recalculated after removal of the disallowed exemption, but (s)he will be liable for "additions to tax for negligence" under IRC 6653.

IRC 6653(a)(1)(A) provides that if any portion of an underpayment of tax is due to negligence or intentional disregard of rules and regulations an amount equal to 5% of the underpayment is added to the tax. IRC 6653(a)(1)(B) provides for an addition to tax equal to 50% of the interest on the portion of the underpayment attributable to negligence. It's a double whammy – a 5% penalty on the underpayment of tax and an additional 50% of the interest on the underpayment (that is in addition to the interest itself).

So what constitutes negligence? Negligence has been defined as the lack of due care or failure to do what a reasonable or ordinarily prudent person would do under the circumstances. In *Nieto v. Commissioner (May 19, 1992)*, Mr. Johnson reported that his two sons lived with him for the entire 12 months, which was proven not to be true. The Tax Court stated that "stating on his returns that two of his children lived with him the entire year when, in fact, they did not, is not the act of a reasonable or ordinarily prudent person. It constitutes (in the very least) negligence."

In his defense, Mr. Johnson argued that he should not be held to be negligent because he had someone else prepare his income tax returns. Nice try Mr. Johnson, but good faith reliance on the advice of a tax professional will protect a party from additions to tax for negligence only in cases where the taxpayer (1) consulted a fully qualified and independent accountant, (2) fully disclosed the facts to him, and (3) then relied on his advice in good faith. Even if you assume that Mr. Johnson's accountant was qualified and well informed, yet still made an error in preparing the returns, that "error" appeared on the face of the tax returns and would have been very obvious to anyone reading those returns. Yet, this "error" was not corrected by Mr. Johnson before the tax returns were filed. Consequently, the Tax Court found that Mr. Johnson was negligent in the preparation of his tax returns.

Let's go back to Form 8332. Regulations provide that a written declaration that the custodial parent will not claim such child as a dependent may be made on a form other than on the official form so long as it conforms to the substance of the official form. Form 8332 requires (1) the name of the children for which exemption claims were released, (2) the specific years for which the claims were released, (3) signature of the custodial parent, (4) Social Security number of the custodial parent, (5) date of signature, and (6) name and Social Security number of the parent claiming the exemption.

The IRS and the Tax Court are real sticklers for following procedure. Just last month, in *Colozza v. Commissioner (June 27, 2006)*, the Tax Court held that a noncustodial parent whose divorce decree awarded him the dependency exemption for his child cannot claim the exemption because his former wife hasn't signed a declaration that she won't claim the dependency exemption deduction.

Although Mr. Colozza's divorce decree provides that he is entitled to the dependency exemption deduction for the child, State courts, by their decisions, cannot determine issues of Federal tax law. Thus, the Court concluded that, pursuant to Section 152(e), Mr. Colozza is not entitled to claim his child as a dependent for the year in question. His recourse, if any, lies in the State court for enforcement of the divorce decree.

Did I mention that Mr. Colozza had not made his child support payments? This is why his former wife would not sign the declaration.

The lesson here? Recognizing that not all divorced parties are always cooperative, it is imperative to get the form signed. It also helps to pay the required support payments.

If you would like additional information, or have a question, please do not hesitate to call.

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.