VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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DEPENDENCY EXEMPTIONS

Don't lose the benefit

When parents divorce, the obligor of child support generally wants to take the dependency exemptions for each of the children on his or her tax return. Depending on the obligor's income level, some or all of the tax benefit may be lost permanently.

For 2006, the personal (dependency) exemption amount is $3,300, and is increased to $3,400 in 2007. However, for any taxpayer whose adjusted gross income exceeds the threshold amount, the exemption amount is reduced by the applicable percentage. *IRC §151(d)(3)*. Because the IRS adjusts many things for inflation, it is important to understand what is meant by "threshold amount" and "applicable percentage".

The threshold amount was set in 1992 and increases annually to reflect inflation. The increase is the same cost of living adjustment utilized to adjust federal income tax brackets each year. The threshold amounts for 2006 and 2007 are as follows:

	2006	2007
Married filing joint	$ 225,750	$ 234,600
Surviving spouse	$ 225,750	$ 234,600
Head of household	$ 188,150	$ 195,500
Unmarried	$ 150,500	$ 156,400
Married filing separately	$ 112,875	$ 117,300

The applicable percentage equals 2% for each $2,500 segment, or fraction thereof, by which the taxpayer's adjusted gross income exceeds the threshold amount. After 2005, a taxpayer subject to the phaseout of personal exemptions is subject to a smaller reduction in the amount of exemptions allowed. For tax years 2006 and 2007, the amount by which the exemption is reduced (the "phaseout amount") is 2/3 of the phaseout amount determined under IRC §151(d)(3); for tax years 2008 and 2009, the amount by which the exemption is reduced is 1/3 of the phaseout determined under the IRC. The phaseout of personal exemptions is eliminated completely in 2010.

Let's take a look at a scenario where the parents have disparate income levels and what happens to those exemptions when one of the parent's adjusted gross income exceeds the threshold amount.

Tax year 2006 and 2007	**Obligor**	**Obligee**
Filing status	Unmarried	Head of household
Adjusted gross income	$ 250,000	$ 60,000
Threshold amount	$ 150,500	$ 188,150
Amount over threshold	$ 99,500	$ -
Phaseout segment	$ 2,500	$ 2,500
Number of segments	40	-
Exemptions for 2 children	$ 6,600	$ 6,600
2% reduction (reduced by 1/3)	$ 3,520	$ -
Allowed exemption for children	$ 3,080	$ 6,600
Applicable federal tax rate	33%	25%
Tax benefit of exemptions	$ 1,016	$ 1,650
Lost tax benefit	$ 1,162	$ -

In our example, the obligee's income does not exceed the threshold, and therefore, is not subject to the phaseout. However, the obligor's income exceeds the threshold amount by $99,500, which is 40 segments of $2,500 (IRS rounds up in this calculation). The amount of exemptions ($6,600) is multiplied 40 times by 2%, and then reduced by 1/3 to determine the reduction of allowed exemptions.

Although the obligor sits in a higher tax bracket, he or she will receive less of a tax benefit than the obligee will. Under this scenario, if the obligor insists on taking the exemptions for the children, the combined households will give the IRS $1,162 in taxes that is unnecessary.

For the next couple of years, until the phaseout is eliminated completely (year 2010), it will be important to keep this reduction in mind. Nobody likes to give the IRS more money than they have to.

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.