

**TAX BENEFITS AND TAX JUSTICE: IS THERE A
MARKET SOLUTION?**

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Abstract

Federal tax law is not considered a symbol of justice. It is a labyrinth of complex rules and statutory obfuscation. Taxpayers are often caught in its web of arcane rules with no apparent recourse. The uncertainty of the tax law makes the planning of one's economic affairs a difficult situation at best. In many cases the tax law forces an inequitable result on taxpayers. There is a feeling among many that justice, as they would define it, is not being served. In this article we explore how, in one particular case at least, taxpayers can actually purchase certain tax benefits from other taxpayers to alleviate some of the injustice that they feel the law directs at them. We look at the potential transfer of dependency exemptions and its concomitant tax credits as an example of how a limited market between certain individuals can be used to realize economic gains from trade between these individuals.

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INTRODUCTION

The Internal Revenue Code, along with the appurtenant regulations and judicial law surrounding it, are not only a confusing mass of arcane language, but sometimes may also lack the application of simple justice. We acknowledge that different people will have different definitions of “justice”. Our intent in this article is not to argue the pros and cons of the Federal income tax system or the ethical dilemmas faced by taxpayers who are contemplating avoiding its grasp. Other scholars, in particular Robert McGee, have already written extensively on this issue.⁴

Rather, our purpose in this article is to argue that in some cases it can be useful for taxpayers to use market forces to foster tax justice, at least as they see it. Briefly, taxpayers can enter into contractual arrangements with other parties in which certain tax benefits can be purchased by one taxpayer from another, as long as both the buyer and seller legally qualify for this tax benefit.⁵ Individuals are often in different tax brackets, which mean that tax benefits are more beneficial to some than others. This differential is the primary incentive for these “tax markets” to arise among individuals.

In this article we concentrate on the market for the dependency exemption for children of the taxpayer, and the related tax credits that are a function of whether or not the child is a qualifying dependent. At the outset we should state that the market for these tax credits is limited to a few individuals who might qualify for the tax benefits. Therefore, when we use the term

⁴ Robert W. McGee, “An Ethical Look at Paying Your ‘Fair Share’ of Taxes,” *Journal of Accounting, Ethics, and Public Policy*, Vol. 2, No. 2, (Spring 1999), pp. 318-328; Robert W. McGee, “Is it Unethical to Evade the Estate Tax?,” *Journal of Accounting, Ethics and Public Policy*, Vol. 2, No. 2, (Spring 1999), pp. 266-285; Robert W. McGee, “Is it Unethical to Evade the Capital Gains Tax?,” *Journal of Accounting, Ethics, and Public Policy*, Vol. 2, No. 3, (Summer 1999), pp. 567-581.

⁵ The key here is that the buyer must qualify for the deduction or credit even in the absence of its purchase from the other party. In IRS Notice 2007-30, March 15, 2007, the IRS clearly stated that the earned income credit could not be sold, but this rule clearly does not apply if the buyer otherwise qualifies for the credit.

“market” we are not using its standard definition of a large number of buyers and sellers. This is a market that for the most part comprises two individuals. Nevertheless there is room for all the price negotiations that occur in more extended markets.

THE DEPENDENCY EXEMPTION: AN OVERVIEW

For tax year 2007 the tax deduction for dependent children, the so-called exemption amount, is \$3,400 for each child. The definition of a qualifying child is usually not a matter of concern except when the parents are divorced, or the child lives in the same abode not only with the parent but perhaps the grandparent as well. The question in these more complex cases becomes just who can claim the child as a dependent. This is where a solution can be found, using the limited market between these individuals.

What is a dependent child anyway? Section 152(c) of the Internal Revenue Code (the Code) allows taxpayers to claim a dependency exemption for qualifying children. To be a qualifying dependent child the individual must meet all four of the following tests:

- 1) Age test: The child must either be under the age of 19 at the end of the year; or be a full-time student under the age of 24 at the end of the year; or be permanently and totally disabled, regardless of age.
- 2) Support test: The child must not have provided over one-half of his or her own support for the year in question.
- 3) Relationship test: The child must be the taxpayer’s son or daughter or any descendent of the son or daughter, e.g., grandchildren. For purposes of this test a child or grandchild includes a stepchild or foster child.
- 4) Principal residence test: The child must have lived with the taxpayer for over half the year in question.

In cases of children of divorced parents, the general rule is that the custodial parent is automatically allowed to claim the child as a dependent, regardless of the amount of support that this custodial parent actually provided for the child. The custodial parent is usually defined in the divorce agreement, but in cases of joint custody the custodial parent is considered the one with whom the child lived for the greater part of the year.⁶

The monetary value of the dependency exemption will depend on the taxpayer's own marginal tax rate. If the taxpayer is in the 30% marginal tax bracket the value of the deduction in 2007 is $\$3,400 \times .30 = \$1,020$. If the taxpayer is in the 10% bracket then the value of the deduction is only $\$3,400 \times .10 = \340 . And, of course, if the taxpayer's income is so low that the marginal tax bracket is -0-, then the value of the dependency deduction is also equal to -0-. These differences in the economic value of the deduction are the genesis of the transactions between two people who both qualify to claim the child as a dependent.

TAX CREDITS RELATED TO THE DEPENDENCY TEST

There are three principal tax credits that are related to the dependency exemption. In other words, if the taxpayer can claim a child as a dependent, then the taxpayer is eligible for these tax credits as well. These three credits are as follows.

The Dependent Care Credit

Section 21 of the Code allows a tax credit if taxpayers expend day-care expenses for their dependent children while the taxpayer is at work. In this case the dependent child must be under the age of 13.⁷ The amount of the credit is 35% of the day-care expenses. The credit base is limited to \$3,000 for one child and \$6,000 for two or more children. The 35% rate is reduced gradually to 20% once the taxpayer's adjusted gross income

⁶ Internal Revenue Code §152(e)(3)(A)

⁷ Internal Revenue Code §21(b)(1)(A)

exceeds \$15,000.⁸ At an adjusted gross income of \$43,000 the reduction stops so that the credit rate never falls below 20%. For purposes of our discussion the taxpayer will have adjusted gross income of less than \$15,000 or more than \$43,000. This is done for the sake of simplicity.

The dependent care credit is not a refundable credit. This means that if the taxpayer's pre-credit tax liability is insufficient to claim the credit, there is no refund of the difference. For example, assume that Joanna has adjusted gross income of \$14,000 and spends \$5,000 for day-care expenses for her two children. Her tentative dependent care credit is $\$5,000 \times .35 = \$1,750$. However, using 2007 figures for the dependency exemption and standard deduction for head of household filing status, Joanna has no taxable income, and therefore no tax liability.⁹ Because she has no tax liability she cannot use any of her credit. It is not a refundable credit, so she gets no cash refund payment from the IRS. Moreover, the unused credit cannot be carried to any future tax year for use when Joanna might have sufficient tax liability. It is simply wasted.

The Child Tax Credit

Section 24(a) of the Code allows a \$1,000 tax credit for each dependent child of the taxpayer under the age of 17. If the taxpayer's pre-credit tax liability is not sufficient to use all of the credit, a portion of the credit is refundable to the taxpayer.¹⁰ The pre-credit tax liability in this case is the tax liability first reduced by the dependent care credit discussed above. The refundability aspect of the child tax credit simply means the IRS will treat the credit in excess of the tax liability in a manner similar to excess tax

⁸ Adjusted gross income is basically taxable income computed before any dependency exemptions or the standard deduction.

⁹ The standard deduction for head of household filers in 2007 is \$7,850. Joanna is allowed not only two dependency exemptions for her children but a personal exemption for herself. Joanna's taxable income is therefore $\$14,000 - \$7,850 - 3 \times (\$3,400) = (4,050)$, which is limited to -0-.

¹⁰ Internal Revenue Code §24(d)

withholding, and refund a portion of the credit to the taxpayer. The maximum amount of the refundable credit is equal to:

$$15\% \times (\text{Earned income} - \$11,750)$$

Thus taxpayers with earned income of less than \$11,750 are not allowed any refundable credit.¹¹ For example, assume that Belinda is single and has two dependent children under the age of 17. She therefore qualifies for a total child tax credit of \$2,000. Assume that Belinda has earned income as a waitress of \$15,750 for the year. She also has some investment income, and her pre-credit tax liability is \$700.¹² The \$700 tax liability is reduced to -0- by the first part of the credit, and Belinda is allowed a refundable tax credit of \$600, computed as follows:¹³

$$.15 \times (\$15,750 - \$11,750) = \$600$$

The Earned Income Credit

Section 32(a) of the Code allows low-income taxpayers an earned income credit [EIC] based on the amount of earned income they have. The credit is also a function of the number of dependent children of the taxpayer. For purposes of the EIC a qualifying child has the same definition as that for dependency exemptions.¹⁴ This

¹¹ The \$11,750 threshold is adjusted annually for an inflation factor.

¹² The standard deduction for a taxpayer filing as head of household is \$7,850. Combined with the exemption deductions for herself and her children, totaling 3 x \$3,400 = \$10,200, Belinda would have no taxable income (and thus no tax liability) if she only had earned income. By providing her with some dividend and interest income we are giving her some positive taxable income and thus a positive tax liability. This is done simply for the sake of pedagogical ease.

¹³ The refundable limit above is for taxpayers with only one or two children. If the taxpayer has three or more children a more complex limit applies. A full discussion of the child tax credit is beyond the scope of a conceptual article such as this. Therefore we limit our analysis to taxpayers with less than three dependent children. The child tax credit is also phased out for high-income taxpayers. We ignore this phase-out to concentrate on the conceptual arguments of our topic. All our taxpayers will have income below the phase-out amounts.

¹⁴ Internal Revenue Code §32(c)(3)

means the child must be under the age of 19 by the end of the year, be a full-time student under the age of 24, or be totally disabled.

For taxpayers with two or more children the EIC for 2007 is 40% of the first \$11,790 of wages. This gives a maximum EIC of \$4,716 in 2007. The credit is gradually phased out once earned income reaches \$15,390 in 2007 and it is totally eliminated once earned income reaches \$37,783.¹⁵ For example, assume that Arlene works as a waitress and has \$15,300 of earned income in 2007. She has two dependent children, ages 10 and 12 respectively, who live with her for the entire year. Arlene's EIC is \$4,716, the maximum amount for 2007. On the other hand, if she is the night manager of the restaurant and has earned income of \$40,000, she has no EIC.¹⁶

The EIC is a totally refundable credit. If the pre-credit tax liability is not sufficient to use all the credit, the entire remainder is refunded to the taxpayer. The pre-credit tax liability for EIC purposes is the tax liability first reduced by all other tax credits. This is beneficial to the taxpayer because all other credits other than the child tax credit are totally non-refundable, so if they can be used first, so much the better. This just leaves more of the EIC that can be refunded. Suppose that Arlene had \$15,300 of earned income for 2007 and \$2,700 of interest income, so her total income is \$18,000. After subtracting her standard deduction of \$7,850 and her three exemptions (\$3,400 each) for herself and her dependent children, she has total deductions of \$18,050. She therefore has no taxable income for the year, and thus no pre-credit tax liability. Let's suppose that she computed a dependent care credit of \$1,200. Because she had two dependent children Arlene also qualified for the \$2,000 child tax credit and the EIC.

¹⁵ These threshold amounts are all subject to an inflation factor each year.

¹⁶ To prevent taxpayers with little earned income but sufficient investment income from claiming the credit, Code section 32(i) provides that taxpayers with more than \$2,900 of investment income in 2007 are not eligible for the EIC. We assume in this article that none of the taxpayers in question have investment income exceeding this amount.

The first “tax injustice” facing Arlene is that she is allowed no dependent care credit because she had no tax liability. This is a totally nonrefundable credit. We will discuss later how Arlene might be able to foster some “tax justice” for herself by selling the tax benefits to another qualifying individual, e.g., her ex-husband.

Will Arlene be able to use all of her \$2,000 child tax credits? No, she has no pre-credit tax liability to use this against, but she will be allowed a partial refund of this credit, as discussed above. Under the refund limitation Arlene’s child tax credit is:

$$.15 \times (\$15,300 - \$11,750) = \$533$$

Arlene’s remaining child tax credit of \$1,467 is lost and cannot be carried to future years for possible use. Again, here is another reason why she might enter the market for tax benefits. Fortunately for Arlene she is able to receive her maximum EIC of \$4,716 because it is a fully refundable credit without limit. Her total refundable credits from the IRS is therefore \$533 + \$4,716 = \$5,249. But even this amount she might be willing to forego if the credits and dependency exemptions are more valuable to another taxpayer who would qualify for the credits. We now turn to a discussion of this potential.

CHILDREN OF DIVORCED PARENTS AND THE TAX MARKET FOR BENEFITS

Current tax law gives the custodial parent the dependency exemption for the children, regardless of which parent actually provides the majority of support.¹⁷ However, the custodial parent can waive this right, letting the non-custodial parent claim the dependency exemption.¹⁸ This waiver also applies in the case of legally separated individuals where one parent has custody of the children. This release of the exemption can be done for one year at

¹⁷ Treas. Reg. §1.152-4T(a).

¹⁸ The waiver is accomplished by having the custodial parent sign Form 8832, **Release of Claim to Exemption for Child of Divorced Parents**. The non-custodial parent then attaches this form to his own tax return for the year.

a time or for multiple-years at a time. By waiving the rights to the dependency exemption for the children the custodial parent is only relinquishing the rights to the exemption and the child tax credit. The custodial parent can still use the more favorable head of household filing status, and is still eligible to claim the dependent care credit and the earned income credit. This is a limited market between two individuals, but it is nevertheless provides an opportunity for mutually beneficial gains from trade for both parties.

Given that ex-spouses are sometimes not on the best of terms, the dependency exemptions (and concomitant child tax credit) are not always, if ever, used by the taxpayer who gains the most from their use. The custodial parent may claim the children as dependents simply because they can. However, “money talks” as the saying goes. The custodial parent can be enticed to sign the aforementioned waiver if the non-custodial parent offers a sufficient monetary reward to the custodial parent for doing so. This offer should be made when there are sufficient differences in marginal tax brackets between the two individuals.

There is no restriction imposed by the IRS against selling these rights, as long as the buyer and seller are both qualifying individuals for the tax benefit. Some might feel this is an “unethical” thing to do, as if the children themselves were being “sold” as a commodity. We see nothing wrong or unethical about this at all. It is simply a case of two individuals engaging in a free exchange of a property right, in this case the right to the dependency exemption. Consider the following example, which is based on the facts from a recent U.S. Tax Court decision.¹⁹

¹⁹ *George Ray Flanigan v. Commissioner*, T.C. Summary Opinion 2007-5: In this case the taxpayer was denied the dependency exemption and child tax credit because the custodial parent did not sign the appropriate waiver. The facts of the case indicated that both parties would have been better off if the non-custodial parent had signed the waiver. Perhaps the court’s decision gave encouragement for this to happen in the future.

Example 1: David and Linda are divorced. Linda has custody of the two children, both of whom are under the age of 10. David provides most of their support through child support payments totaling \$2,000 per month. In addition he pays Linda \$1,000 per month in alimony. The alimony is taxable income to Linda, and is a tax deduction for David, who has remarried and is filing a joint return with his new wife. After taking the alimony deduction the taxable income on their joint return is \$85,000, which puts David and his new wife in the 25% marginal tax bracket.

Are there “gains from trade” to be made here if Linda waives her right to the dependency exemption to David? Suppose that Linda does not waive the rights to David. What is her final tax liability? We assume that Linda qualifies for head of household filing status and uses the standard deduction in computing taxable income. The standard deduction in 2007 is \$7,850 and Linda is allowed three exemptions, one for herself and one each for her two children. If she does not sign the waiver her taxable income is limited to -0-, as computed below:

<i>Alimony</i>	<i>\$12,000</i>
<i>Standard deduction</i>	<i>(7,850)</i>
<i>Exemptions (3 x \$3,400)</i>	<i><u>(10,200)</u></i>
<i>Taxable income [limited to -0-]</i>	<i>-0-</i>

Linda does not qualify for any tax credits at all. She is not eligible for the child tax credit because she has no tax liability. Moreover, alimony is not considered earned income so there is no partially refundable child tax credit under those rules. Alimony is also not considered earned income for purposes of the EIC.²⁰ She has every incentive to transfer the dependency exemptions to David. If she does so, what is her resulting tax liability? She loses the two dependency exemptions, and thus deductions of \$6,800,

²⁰ Internal Revenue Code §32(c)(2)(A)

but she still retains the head of household filing status. Therefore her tax liability after the waiver is:

<i>Alimony</i>	\$12,000
<i>Standard deduction</i>	(7,850)
<i>Exemptions (1 x \$3,400)</i>	<u>(3,400)</u>
<i>Taxable income</i>	\$ 750

Linda's tax rate on this amount is only 10%, yielding a final tax of \$75. Therefore, this sets the minimum amount that she is willing to take if she is to sell the dependency exemption to David for one year. This is the lower boundary of the negotiated price between the two of them. What about David? Based on 2007 tax rate schedules the marginal tax rate for David and his new wife remains at 25% after the extra \$6,800 of deductions are taken in their joint tax return. This will generate additional tax savings of $\$6,800 \times .25 = \$1,700$. In addition they should be able to claim the full \$2,000 of child tax credits, given their pre-credit tax liability.²¹ David's tax benefit in total is:

<i>Tax savings from 2 dependency exemptions</i>	\$1,700
<i>Child tax credits</i>	<u>2,000</u>
<i>Additional tax benefits</i>	\$3,700

This amount sets the upper limit on the negotiated price between David and Linda for one year's transfer of the dependency exemption. The range is therefore \$75 to \$3,700 and there are gains from trade to be made here, if David and Linda can agree on a price. Let us say that David offers \$2,000 to Linda if she agrees to waive the dependency exemptions. Linda is better off by \$1,925 and David (and his new wife) is better off by \$1,700. In a legally free exchange between consenting adults both David and Linda are

²¹ The taxable income on the joint return for David and his new wife is now $\$85,000 - \$6,800 = \$78,200$. The 2007 income tax before taking the child tax credit is $\$8,773 + .25 (\$78,200 - \$63,700) = \$12,398$. The child tax credit reduces this to \$10,398.

better off than they were before. There are clearly gains from trade for both parties to the transaction.

The dependency exemption (and the child tax credit with it) can be waived for a multiple of years at a time, so if David and Linda expect to be in similar circumstances for the next few years, then the negotiated sales price can be adjusted to take this into account. The upper limit should represent the present value of the tax savings to David for the future time period. The lower limit should be the present value of the additional tax that Linda will pay if she makes the multiple-year waiver. Based on these estimates, perhaps Dave is willing to offer, and Linda is willing to accept, an offer of \$5,500 for her waiver for the next three years.

Of course, both parties to the transaction should have all the necessary information to consummate a mutually beneficial exchange. For example, the child tax credit only applies to children who are under the age of 17.²² A non-custodial parent seeking to have the custodial parent sign a multiple-year waiver must take into account the ages of the children over the multiple-year period. This information is crucial for negotiating the exchange price with the custodial parent.²³ Changes in future tax rates of the individuals are also a critical factor to consider, as well as the chance that tax law itself could be altered. For example, if David thinks that Congress is apt to repeal the child tax credit,

²² For tax purposes age is determined at the end of the year. A child who turns 17 in December is considered 17 for the entire year, and is therefore not an eligible child for the tax credit.

²³ It is the position of the IRS that this waiver rule for divorced and separated parents also applies to parents who have never been married. See Internal Revenue Service, *Publication 17: Your Individual Income Tax [2006]*, Chapter 3, page 28. Under the current demographic conditions in the United States this is more and more a common lifestyle. The custodial parent in this case is the one with whom the child lived most of the time during the year. This parent automatically receives the dependency exemption for the child, along with any child tax credits and other credits, e.g., earned income credits, which are related to the exemption. These can be transferred, by sale or otherwise, to the non-custodial parent.

this will certainly affect how much he is willing to offer for a multiple-year waiver.

THE MARKET FOR CREDITS BETWEEN INDIVIDUALS OTHER THAN DIVORCED PARENTS

It is not only divorced or separated individuals who can engage in these quasi-market transactions for dependency exemptions and credits. Consider the following example.

Example 2: Diana is divorced and has two children, age 10 and 12. Her ex-spouse has abandoned her and does not provide any support for her or the children. Diana and the two children live with her mother, Sue. Together they provide over one-half the support of the two children. Diana has earned income of \$6,000 from a part-time job. In addition she receives various governmental benefits, i.e., food stamps and Medicaid, with a total value of \$5,000 for the year. These are nontaxable items and are also not considered earned income to Diana. Her mother Sue has \$50,000 of earned income and \$4,000 of interest income from a bank certificate of deposit. Their combined expenditures for day care credit are \$3,000 for the current year. Virtually all of their combined income was used for household support other than a small amount of savings set aside by Sue.

Under the scenario described above, both Diana and Sue can claim the two children as dependents. First, the children are both under age 19. Secondly, the children meet the definition of “child” for both Diana and Sue. Grandchildren of a taxpayer qualify as a “child” for purposes of the dependency exemption. Thirdly, the children do not provide over one-half their own support. Finally, the children lived with both Diana and Sue for most of the year. Given these facts, either Diana or Sue can claim the dependency exemption. However, both cannot do so.

Fortunately the tax law allows either Diana or Sue to make this decision on an annual basis. The decision is made simply by having the designated person claim the children as dependents on

their tax return for the year in question. Absent any decision the default rule is to give the dependency exemption to the parent, in this case Diana.²⁴ Whoever is allowed the dependency exemption is also allowed the following tax benefits:

- 1) child tax credit;
- 2) head of household filing status;
- 3) dependent care credit; and
- 4) earned income credit (EIC)

Therefore, unlike the rule for divorced parents, where only the dependency exemption and the child tax credit can be transferred, virtually every tax benefit related to the dependency exemption can be transferred in this case. The taxpayer claiming the children as dependents is allowed all of the foregoing benefits. The person not claiming the children cannot use any of them. In other words, it is an “all or nothing” situation. The two individuals, Diana and Sue for example, cannot choose to transfer just one of the credits or the head of household filing status. The person not claiming the children must file as a single individual with no dependents, and cannot use any of the related credits.

Obviously there is room here for some mutually beneficial gains from trade between both individuals. Again, there are those who would think such buying and selling of these rights is “unseemly,” that it amounts to treating children like “commodities” or “tax slaves,” to be bought and sold like so much property, as if Diana and Sue were engaging in some type of insidious endeavor. We argue that there is nothing unethical about two consenting adults engaging in transactions that only benefit themselves, and which certainly has no effect on the children’s well-being. After all, it is not the children that are being sold, but only a tangential tax benefit, i.e., a property right, that is attached to them by statutes enacted by the U.S. government.

²⁴ Internal Revenue Code §152(c)(4)(A)

What are the possible gains from trade here between Diana and Sue? We will start with the default scenario that gives Diana the dependency exemption, and then compare this to the situation that arises if Diana agrees to let Sue claim the children as dependents. We use 2007 tax information in our analysis.

The Children are Dependents of Diana

If Diana claims the children as dependents, the following tax consequences result for both her and Sue. We assume that both use the standard deduction in computing their taxable income. For 2007 the standard deduction for head of household is \$7,850 and for single taxpayer it is \$5,350. Each is allowed a personal exemption of \$3,400 and another \$3,400 for each dependent claimed. In this first scenario Diana will file as head of household and Sue as a single taxpayer.

Diana:

<i>Earned income</i>	\$ 6,000
<i>Standard deduction</i>	(7,850)
<i>Exemptions [3 x \$3,400]</i>	<u>(10,200)</u>
<i>Taxable income [limited to -0-]</i>	<u>\$ -0-</u>
<i>Tax liability</i>	\$ -0-
<i>Dependent care credit ^a</i>	-0-
<i>Child tax credit ^b</i>	-0-
<i>Earned income credit [40% x \$6,000]</i>	<u>(2,400)</u>
<i>Tax refund</i>	<u>\$(2,400)</u>

^a Because there is no tax liability there is no dependent care credit allowed.

^b Because earned income is less than \$11,750 there is no partial refund of the child tax credit.

Sue:

<i>Earned income</i>	\$50,000
<i>Interest income</i>	4,000
<i>Standard deduction</i>	(5,350)
<i>Personal exemption</i>	<u>(3,400)</u>
<i>Taxable income</i>	<u>\$45,250</u>
<i>Tax liability: \$4,386 + .25(\$45,250 - \$31,850)</i>	\$7,736
<i>Credits</i>	<u>-0-</u>
<i>Tax liability^c</i>	<u>\$7,736</u>

^c This is before any refund for income tax withholding.

It is fairly obvious that Diana and Sue are not maximizing the tax benefits of the household. Diana does not need all of the standard deduction for head of household, nor does she need the head of household tax rates, given her taxable income is -0-. She also gets no use of the child tax credit or dependent care credit. The only tax benefit she derives is from the earned income credit (EIC), which is a fully refundable credit.

The Children are Dependents of Sue

What if Sue is allowed to claim the children as dependents? In that case Sue can claim head of household filing status, obtaining a larger standard deduction and using the more favorable tax rate schedule to compute her tax liability. In addition all of the credits would transfer to her. Diana would have to give up the earned income credit, so she is worse off by \$2,400.

Diana:

<i>Earned income</i>	\$6,000
<i>Standard deduction</i>	(5,350)
<i>Personal exemption</i>	<u>(3,400)</u>
<i>Taxable income [limited to -0-]</i>	<u>\$ -0-</u>
<i>Tax liability</i>	\$ -0-
<i>Credits</i>	<u>-0-</u>
<i>Refund</i>	<u>\$ -0-</u>

Sue:

<i>Earned income</i>	\$50,000
<i>Interest income</i>	4,000
<i>Standard deduction</i>	(7,850)
<i>Exemptions: [3 x \$3,400]</i>	<u>(10,200)</u>
<i>Taxable income</i>	<u>\$35,950</u>
<i>Tax liability: \$1,120 + .15(\$35,950 - \$11,200)</i>	\$4,833
<i>Dependent care credit: \$3,000 x 20%^a</i>	(600)
<i>Child tax credit</i>	(2,000)
<i>Earned income credit^b</i>	<u>-0-</u>
<i>Net tax liability^c</i>	<u>\$2,233</u>

^a Because Sue's adjusted gross income of \$54,000 is greater than \$43,000, her dependent care credit percentage is limited to 20%.

^b Because Sue's earned income of \$50,000 is greater than \$37,783 any earned income credit has been totally phased out for her.

^c This is before any refund for income tax withholding.

The Gains from Trade for Diana and Sue

From the foregoing analysis it is obvious that the household is better off by having Sue claim the children as dependents. Diana has given up her \$2,400 earned income credit (EIC), so she is worse off individually by that much. The EIC is not claimed by Sue in this case, because her income is too high. It is simply lost to the both of them. However, Sue's overall tax liability has still decreased from \$7,736 down to \$2,233. This is a net gain to her of \$5,503, so she is better off by that much. The boundaries for the gains from trade are thus \$2,400 to \$5,503.²⁵

²⁵ The income tax withholding that might lead to some type of refund for Sue is irrelevant for purposes of our analysis.

Now, we readily admit that Diana and Sue could agree to do this without any consideration being transferred from Sue to Diana. Indeed this may occur. But human nature being what it is, this is not a foregone conclusion, despite what many might think will, or should, happen. Diana may have individual wants and desires that she is not willing to give up simply to have the household better off. She may feel that most of the benefit will simply inure to Sue if she gives up the dependency exemption for the children. Thus there is a strong likelihood that money or some other type of consideration will have to change hands here.

Let's assume that Sue agrees to pay Diana \$3,000 if Diana agrees to let Sue claim the children as her dependents. Diana will be better off by \$600 than if she claimed the children herself, and received the EIC refund of \$2,400. Sue will be better off by \$2,503 if she claims the children as dependents instead of Diana. This \$2,503 is equal to Sue's \$5,503 income tax reduction less her \$3,000 payment to Diana.

IS THERE A STEALTH TAX ON THE EXCHANGE?

Are there any other tax consequences to these transactions? Does the person who sells the tax benefits owe any tax on the sale? This is an interesting question, and there is no definitive answer here. Section 61(a) of the Code defines gross income, i.e., income subject to taxation, as "...all income from whatever source derived." Of course the Code then exempts many types of income from taxation, e.g., interest income on state and local government bonds, life insurance proceeds, inherited property, etc. Would the IRS consider the sale of tax benefits to be taxable income? Undoubtedly it probably would, but if it did, there are other tax consequences that it should then grant to the purchaser of these benefits. In addition there is the dilemma of defining the proper amount of income for the seller to report in the first place.

We will use the example of Diana and Sue from the previous example to explain this point. Let's assume that the negotiated price is \$3,000. Diana has given up a \$2,400 EIC in exchange for \$3,000, which makes her \$600 better off. What is her

taxable income from this? The IRS would undoubtedly say \$3,000, but isn't it really just \$600, which is Diana's net increase in wealth here? Perhaps this distinction is not important for most taxpayers who sell these benefits, because they are often in the lowest or even "zero" tax brackets. For example, even if Diana reports \$3,000 as income from the sale, she would still pay only \$25 of tax, as her taxable income would only be \$250, as shown below. This puts her in the lowest tax bracket of 10%.

<i>Earned income</i>	<i>\$6,000</i>
<i>Sale of benefits</i>	<u><i>3,000</i></u>
<i>Total income</i>	<i>9,000</i>
<i>Less: Standard deduction</i>	<i>(5,350)</i>
<i>Less: Personal exemption</i>	<u><i>(3,400)</i></u>
<i>Taxable income</i>	<i>\$ 250</i>

If the sale of these benefits is a taxable transaction then the seller will most likely adjust slightly upward their minimum asking price to take into account the small amount of tax owed. The fact that these sellers of tax benefits are in such low or nonexistent tax brackets means that counting the sales proceeds as taxable income should in no way be an economic deterrent that would stop the transaction from being made.

What about the buyer of these tax benefits? Is the buyer allowed any favorable tax consequences? If a taxpayer purchases inventory for say, \$10,000, this is their cost basis in the inventory. If the inventory is later sold for \$15,000 the taxpayer only has \$5,000 of net income to report. The cost basis is subtracted from the sales price and reduces the gain from the sale. In the preceding example hasn't Sue bought a property right for \$3,000? If so, does she get a tax deduction for \$3,000 because she has now obtained the net increase in cash flow from their use in her tax return? Can she treat it much like a traditional sale of inventory?

If the IRS is consistent in its approach, then forcing Diana to report \$3,000 of income necessitates giving a tax deduction of \$3,000 to Sue. Given that Sue is in a higher tax bracket than Diana,

there will be a net loss to the IRS for this consistent treatment. If Sue's tax liability increases by \$25, Diana's will decrease by $\$3,000 \times .15 = \450 . This is a net loss to the IRS of \$425. Given these facts it is likely that the IRS will ignore the taxability of these transactions. There is no economic incentive for it to assert that the income is taxable. Most likely the IRS would just let "sleeping dogs lie" in this situation. Moreover, there is a question of whether or not tax law would even support the idea that these transactions are taxable. The corollary problem of how to treat the buyer is problematic and something the overburdened U.S. Tax Court would certainly not be keen to decipher. These are all intriguing questions by themselves, but unfortunately they are beyond the scope of this article.

CONCLUSION

As our examples have illustrated, there may be substantial tax benefits (credits or deductions) that are permanently lost if the custodial parent has a lower income than an ex-spouse or another higher earning family member, and claims the children as dependents for tax purposes. If we were to encourage these individuals to waive the dependency rights in exchange for compensation, both parties to the exchange would gain. The concept of mutual gains from voluntary exchange is fundamental to economics.

Additionally, our point is that there is nothing unethical about allowing individuals to harvest these gains, particularly since there is nothing unethical in the underlying exchanges. Nobody is harmed in the process, unless you consider the IRS. But if the IRS is always considered in this analysis, then individuals should never engage in any legally tax-motivated behavior or tax planning because the IRS would stand to collect less revenue. Are individuals not to engage in mutually beneficial exchanges simply because Federal tax revenue is harmed by the process? Such a conclusion is patently ridiculous in a free society.

However, we understand that some may characterize our discussion as a cold application of economics to a familial

situation. Many might think it “unseemly” that people will buy and sell tax benefits related to their children, as if the children themselves were being sold. We reject this criticism. As one of the foremost economists exploring human behavior, Nobel Laureate Gary Becker faced similar criticism when he began his famous study of family behavior. His position on this is aptly summarized by the following statement.²⁶

The economic approach to the family assumes that even intimate decisions such as marriage, divorce, and family size are reached through weighing the advantages and disadvantages of alternative actions. The weights are determined by preferences that critically depend on the altruism and feelings of duty and obligation toward family members.

In other words, the tools of economics are completely appropriate in these situations. The key is in the application of the tools. We are merely suggesting that when the relationships are better characterized as “extra-familial,” that the feelings of altruism, duty, and obligation may either be replaced by more inward-focused and self-interested concerns or a recognition that these feelings will motivate the exchanges we encourage. In this way, these individuals may be able to turn their tax situation into one that they feel better reflects their definition of justice.

²⁶Gary Becker, “Nobel Lecture: The Economic Way of Looking at Behavior,” *The Journal of Political Economy*, Vol. 101, No. 3, (June, 1993), 385-409. The quote is found at page 402 of the article.