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Ask the CPA -- The Impact of the Tax Cuts and Jobs Act on Divorce and Custody Cases

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As a practicing family law attorney who does not have formal training in accounting and tax matters, I rely on my forensic accounting experts to advise my clients on the tax consequences of the issues unique to their circumstances. However, having a working knowledge of the tax law matters that frequently come into play in the negotiation of divorce and child custody agreements is valuable, if only to highlight the importance to the client of seeking the advice of a licensed accounting professional. For example, with the new law's repeal of the dependent exemptions, yet expansion of the child tax credit, a family law attorney will want to change how he or she drafts provisions relating to tax benefits associated with a child that are often a hot-button issue at 4:00 p.m. in mediation.

It is with this in mind that I asked Bryan to indulge me with a little Q & A about the 2018 tax law changes. We'll start with the ones that relate to child custody matters and divorces with children, and then graduate to those relating to the more complex business appraisal issues. The Tax Cuts and Jobs Act ("TCJA",) was signed into law by the President on December 22, 2017, and most of the changes introduced by the bill went into effect on January 1, 2018.

1. Although the dependency exemption has been eliminated, what child-related tax benefits are still left that a lawyer may want to consider addressing in the settlement agreement and decree?

The Tax Cuts and Jobs Act eliminated the dependency exemption for tax years beginning after December 31, 2017. However, this is somewhat mitigated by the increases in the standard deduction.

However, the child tax benefits enumerated below were not eliminated by the Tax Cuts and Jobs Act, and the divorced parent who is eligible for those benefits is the one who would have qualified to take the dependency exemption (for example, as specified in a decree and where the custodial parent provides a Form 8332 to the noncustodial parent).

a. **Head of household filing status** [Internal Revenue Code Section 2(b)]

A parent may be able to file as head of household if he or she meets all the following requirements.

1. The parent is unmarried or considered unmarried on the last day of the year;
2. The parent paid more than half the cost of keeping up a home for more than half of the year; and
3. A qualifying person lived with the parent in the home for more than half the year (except for temporary absences, such as school); however, if the qualifying person is your dependent parent, he or she doesn't have to live with you.

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If a parent qualifies to file as head of household, his or her tax rate will usually be lower than the rates for single or married filing separately. He or she will also receive a higher standard deduction than if he or she files as single or married filing separately ($18,000 vs. $12,000).

For more information concerning qualifying for head of household status, see IRS Publication 501(2018), Dependents, Standard Deduction, and Filing Information.

b. **Child Tax Credit** [Internal Revenue Code Section 24]

Effective January 1, 2018, the TCJA expands the Child Tax Credit (formerly $1,000 per child under the age of 17). Under the new law, the credit is increased to $2,000 per child, and $1,400 is refundable, meaning if the credit exceeds the tax liability, up to $1,400 of the credit is refundable. A $500 non-refundable credit was added for other dependents. The phase out level was increased dramatically, starting at $400,000 for married filing joint returns ($200,000 for all other taxpayers-formerly phased out from $110,000 married filing joint/$75,000 other filing statuses). A valid social security number must now be provided for each child for which the credit is claimed but the $500 credit is allowed for a child without one.

c. **Child and dependent care tax credit** [Internal Revenue Code Section 21]

The Child and Dependent Care Credit, which allows a parent to deduct qualified child care expenses incurred while a parent works or looks for work, has been kept in place. To claim the tax credit for children of divorced or separated parents, the parent must have earned income and the following requirements must be met:

1. The care must be for a child who was under age 13 or wasn't physically or mentally able to care for himself;
2. the child received over half of his or her support during the calendar year from one or both parents who are divorced or legally separated under a decree of divorce or separate maintenance, are separated under a written separation agreement, or lived apart at all times during the last six months of the calendar year;
3. the child was in the custody of one or both parents for more than half the year; and
4. you were the child's custodial parent.

IRS Publication 503, Child and Dependent Care Expenses at 4. Publication 503 defines the custodial parent as the parent with whom the child lived for the greater number of nights in the calendar year. If the child was with each parent an equal number of nights, the custodial parent is the parent with the higher adjusted gross income. *Id.*

If a parent qualifies, the credit is 20%-35% of qualified expenses. The percentage depends upon the parent's adjusted gross income. The maximum amount of qualified expenses allowed to calculate the credit is:

$3,000.00 for one qualifying person;
$6,000.00 for two or more qualifying persons.

If the parent has a Section 125 plan, also known as a cafeteria plan or flexible spending account, he or she may reduce his or her income by contributing up to $5,000.00 in pre-tax dollars to the plan for childcare or medical expenses.

A parent cannot use both the Child and Dependent Care Credit and the Section 125 funds to cover the same child care costs; however, they may both be used for different care providers or different qualifying children. For additional details, see IRS Publication 503, Child and Dependent Care Expenses at www.irs.gov.

d. **529 Accounts** [Internal Revenue Code Section 529]

Under the prior law, distributions from a 529 account were limited to post-secondary educational expenses, such as tuition, fees, books, supplies and equipment required for the enrollment or attendance at an eligible educational institution. The TCJA allows distributions from a 529 account to be used to pay up to a total of $10,000 of tuition per beneficiary (regardless of the number of contributing plans) each year at an elementary or secondary school. *See* IR-2018-156, July 30, 2018. The allowance sunsets on December 31, 2025.

If 529 plans or other college/education savings vehicles are part of the estate and provisions in a mediated settlement agreement are being made regarding who pays for college, consideration should be given as to the timing of the use of the funds (i.e. will the person who is the custodian of the accounts be required to exhaust the funds in the accounts prior to the other person having to pay). Typically, Courts do not make orders regarding children once they are past the age of majority in their State, unless they are special needs children. Also, the possibility that children will not go to college or attend private school should be considered along with a provision for the disposition of the funds in that situation. Also, who is the "owner" of college savings accounts should be considered in light of financial aid applications. For example, if the custodial parent is the owner, the assets are reported as assets on the FASFA form but distributions from those plans are ignored. However, if the noncustodial parent is the owner, the asset is ignored by the custodial parent in their application for financial aid but any distributions would be considered as "income" for the child, which could reduce aid eligibility

e. **Education Tax Credits** [Internal Revenue Code Section 25A]

A parent can claim the American Opportunity or Lifetime Learning Scholarship higher education tax credit (subject to AGI-based phaseout rules which eliminate many from eligibility) for qualified tuition and related expenses incurred for a child for whom that parent can claim a dependency exemption deduction.

f. **Student Loan Interest Deduction** [Internal Revenue Code Section 221]

A parent can claim a deduction for up to $2,500 of qualified education loan interest expense (subject to AGI-based phaseout rules) incurred for a child who is that parent's qualifying child under the Section 152 rules.

g. **Tuition Deduction** [Internal Revenue Code Section 222].

A parent can claim a deduction for up to $2,000 or $4,000 of qualified tuition and related fees (subject to AGI-based disallowance rules) for a child for whom that parent can claim a dependency exemption deduction. This provision expired after 2016 but may be extended by legislation.

2. What is the effect of the TCJA repealing the deduction for alimony payors, and do you have any concerns as to how it may affect divorce cases in Texas?

Moving forward, for divorces finalized on or after January 1, 2019, alimony will be considered a nondeductible personal expense of the payor spouse, and the recipient spouse will not be required to claim the alimony payments as income. This results in the income used for alimony payments to be taxed at the (usually) higher rates applicable to the payor spouse rather than the (usually) lower rate applicable to the recipient spouse. In addition, the legal fees paid to attorneys to help secure alimony payments will no longer be tax deductible due to the elimination of the miscellaneous itemized deductions (all of them, not just legal fees).

As far as how that change may affect divorce cases, it will no longer be necessary to "gross up" the recipient's alimony payment for the taxes they would have had to pay on them. Also, there will no "alimony arbitrage", i.e. the excess of the payor's tax rate over the payee's tax rate times the alimony payments. Therefore, the payee will receive less in alimony payments in "gross" absolute terms, but since tax does not have to be paid on the payments received, should receive the same net amount. However, the lack of taxability on the alimony payments may allow the payee spouse to enjoy a lower rate on their other income.

Further, premarital and partition agreements containing provisions for the payment of tax-deductible alimony may be affected by these tax changes, so those agreements should be reviewed.

3. How might the elimination of personal and dependent exemptions affect negotiations for miscellaneous deductions in a divorce case?

Under TCJA, starting in 2018, the deduction for personal exemptions eliminated. *See* IRS Publication 501(2018), Dependents, Standard Deduction, and Filing information at 1. While the new law eliminates personal and dependent exemptions, the standard deduction for taxpayers who don't itemize their deductions on Schedule A of Form 1040 is higher for 2018 than it was for 2017. The amount depends on your filing status. The 2018 Standard Deduction Tables are contained in Publication 501. The Standard Deduction Chart for Most People is set out below:

Table 6.Standard Deduction Chart for Most People*

IF your filing status is...	YOUR standard deduction is...
Single or Married filing separately	$12,000
Married filing jointly or Qualifying widow(er)	24,000
Head of household	18,000

*Don't use this chart if you were born before January 2, 1954, or are blind, or if someone else can claim you (or your spouse if filing jointly) as a dependent. Use Table 7 or 8 instead.

While the standard deduction is higher, several popular deductions for miscellaneous deductions were eliminated, such as tax preparation fees, investment advisory fees, unreimbursed work expenses (travel, parking, meals and entertaining), depreciation on phone or computer required for work, investment expenses and job search expenses.

In addition, the mortgage interest deduction and the state and local tax deductions have been limited. The mortgage interest deduction is limited to interest on up to $750,000 in debt on a primary or secondary home (no change for existing mortgages) and the state and local tax deduction is capped at $10,000 of expenses (property and sales or income tax, regardless of filing status).

For some taxpayers, the higher standard deduction coupled with the elimination or reduction of several popular deductions will obviate the need to itemize. In some cases, this may serve to reduce disagreements relating to the deduction for mortgage interest and taxes going forward (see Section 4. Below).

4. Can you explain the reduction in the mortgage interest and state/local tax deductions and the interplay with the increased standard deduction?

Starting with taxable years beginning after December 31, 2017, the maximum mortgage amount on which home mortgage interest will be deductible is $750,000 ($375,000 for married filing separately status). Previously, the limitation was $1,000,000 ($500,000 MFS).

The $750,000 (previously $1,000,000) is known as "home equity indebtedness "("HEI"). HEI is limited to the original amount of the loan to acquire the residence, and any subsequent reductions in the original amount.

Taxpayers may continue to deduct interest on up to $100,000 of home equity loans (in addition to the HEI) but will now only be able to deduct interest on a home equity loan if the loan is used to improve the residence (instead of cash-out refinancings to pay personal expenses or debts).

Taxpayers may continue to deduct state, local, and foreign income and property taxes incurred in connection with the carrying on of a trade or business or rental activity (i.e. on business returns and Schedule C and Schedule E of a Form 1040) without the limitation discussed below.

For sales taxes on consumer items, property taxes on non-business assets, and income taxes on non-business income, the deduction is now limited to $10,000 per year. So, higher income taxpayers with property tax bills in excess of that amount will simply be limited to the $10,000 per year.

Therefore, in light of the standard deduction increasing, since one gets to take the greater of the standard deduction or the itemized deduction, the eligibility for the deduction for mortgage interest and taxes may be a less important issue in negotiating divorce cases going forward.

5. What has happened to miscellaneous itemized deductions such as fees for tax planning and preparation and legal fees?

Miscellaneous Itemized Deductions have been eliminated. Effective with the 2018 tax year, all of the deductions associated with the "Miscellaneous Itemized Deduction" category are no longer allowed. Of note to divorce practitioners, this category included fees for tax planning, preparation and advice, and expenses incurred for the production of income (such as legal fees that resulted in a taxpayer receiving alimony).

6. I heard changes were made to Section 1031 exchanges-what happened?

Most are familiar with the opportunity that taxpayers have to exchange real estate in so-called "1031 transactions" or "Like-Kind" exchanges. To the extent property held for business or investment purposes is exchanged by taxpayer, neither recognizes gain or loss on the transaction. Rather, the basis of the property transferred carries over to the property received and gain or loss is recognized when the replacement property is finally sold. Previously, the like kind exchange provisions applied to both real and personal property. For example, business automobiles traded in for new business automobiles were included within the purview of Section 1031. Effective January 1, 2018, the like-kind exchange rules will only apply to real estate transactions.

7.. Many individuals going through a divorce have Net Operating Losses to consider and divide-were any changes made to Net Operating Losses?

Net Operating losses -the excess of business deductions over business income-are a tax attribute that can be divided in a divorce. Technically, the division of an NOL is done based on a pro-forma tax calculation for the year the loss arose-and the NOL is divided in proportion to the loss that would have been incurred on each taxpayer's separately filed tax return-which means in a community property state, that the loss would be divided equally assuming all items of income, loss, gain, deduction and credit were community in nature.

Under old law, NOL's could be carried back two years and forward twenty to offset business income in those years. The TCJA limits the amount of NOL deduction carried back or forward to 80% of the income in the carry back or carry forward year. Additionally, the two-year carryback period is repealed except in the case of certain losses incurred in farming and a one-year carryback for certain small businesses.

This provision will alleviate the problem of a loss arising for a single taxpayer in a post-divorce year who wanted to carry back a loss to a pre-divorce year. This would usually result in the other spouse demanding a share of the tax refund arising from the carryback or refusing to assist in the filing of an amended return for the loss year.

8. Are there any new provisions that assist the IRS in collecting past due taxes?

IRS Notice 2018-1 requires the Department of the Treasury to Notify the U.S. Department of State if a certification is made that a taxpayer has a "seriously delinquent tax debt."

Upon receipt of such a certification, the State Department has the authority to deny a passport application or revoke a previously issued passport. A "seriously delinquent tax debt" is an unpaid, legally enforceable and assessed federal tax liability of an individual that is greater than $50,000 where:

1. A notice of federal tax lien has been filed and the taxpayer's right to a hearing under Section 6320 has been exhausted or lapsed;
2. A levy has been issued under Section 6631.

A “seriously delinquent tax debt” does not include:

1. A debt that is current under an installment agreement with the IRS;
2. A debt that is current under an Offer-In-Compromise with the IRS;
3. A debt that is current under a settlement agreement with the Justice Department;
4. A debt due to a levy for which collection is suspended because of a request for a due process hearing;
5. A debt for which collection is suspended because of an innocent spouse election (Section 6015 (b) or (c)) or requested innocent spouse relief (6015(f).

Procedures exist for the IRS to notify the State Department when such a debt is paid or becomes legally unenforceable and an individual must be notified by the IRS when the individual is subject to certification as having a seriously delinquent tax debt or when that certification is reversed. This provision could impact the travel plans and abilities of divorced parents with past due taxes and provisions in divorce decrees regarding passports of adults.

9. Is it true that new opportunities exist for the deferral of income (for tax purposes) for those who exercise compensatory stock options or have vestings of Restricted Stock units in privately held companies?

Yes-the TCJA allows for a qualified employee to elect to defer the income that would have been recognized on the lapse of restrictions on “qualified stock” (stemming from Restricted Stock Units or upon the exercise of a stock option). The income deferral period can be as long as five years after the date of the vesting of the RSU or Option. The election to defer the income must be made no later than thirty days after the vesting of the RSU or option. “Qualified stock” is that which is received by the employee pursuant to the settlement of an RSU or exercise of a stock option that was granted by an “eligible corporation.” An “Eligible Corporation” is one whose stock is NOT traded on an established exchange or established securities market. Qualified stock ceases to be so when it can be exchanged with the corporation for cash or when the corporation goes public.

The deferral is only available to an “eligible employee” which is defined as one who is not an “excluded employee.” An “excluded employee” is one who was 1) a 1% owner of the entity at any time during the ten preceding years, 2) the CEO or CFO presently or at any time in the past, 3) a family member of a person described in 1) or 2), 4) one of the four highest compensated officers of the corporation at any time during the last ten years.

When an RSU vests or a stock option is exercised where the underlying stock is transferred on an established exchanged, it is a simple matter to determine the taxable income due to those events and upon lapse or exercise, the employee can use a portion of the stock received to pay for the income, FICA, and Medicare tax withholding. However, this is generally not possible when the underlying stock is not traded on an exchange and is illiquid. The employee must tap other sources to pay the tax due on the lapse of the RSU or exercise of the option. With this deferral provision, the employee gets relief for up to five years. However, the employee still must pay applicable FICA and Medicare tax at the time of lapse or exercise. Practitioners should be aware of this tax deferral tool and ask their client (or spouse of their client) if there are any outstanding deferrals in order to properly assess the pending tax issues of the estate being divided. An employee who has previously deferred income under this provision can revoke the deferral prior to the end of the five-year period, or income recognition could be triggered if the corporation ceases to be an “eligible corporation,” the employee becomes an “excluded employee,” or the stock is no longer “qualified stock.”

If your client has deferred income under this provision, be sure to consider the future tax that will be paid at the end of the deferral period in this division of the estate, much like tax affecting a retirement plan balance.

However, keep in mind this provision DOES NOT apply to options or restricted stock units of publicly traded companies, which comprise the majority of those items of compensation that practitioners encounter.

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10. What new provisions in the tax law could affect business valuations?

Having a basic understanding of federal tax issues regarding business income is important in understanding business valuations, as federal tax planning has an impact on the timing of income and deductions and the benefits and drawbacks of the various forms of business entities. The TCJA has numerous and complex provisions affecting business entities. The following two provisions are noteworthy.

-QBI

Since TCJA implements a flat 21% tax rate on C corporations, a corresponding provision was enacted relating to pass-through entities-the "Qualified Business Income" deduction (QBI).

A full discussion of QBI is beyond the scope of this paper. However, the question of how this could affect business value is important when it comes to the issue of the appropriate tax rate to apply to a pass-through entity's income stream. Recall that a debate has existed in the appraisal profession as to whether it is appropriate to tax affect a pass-through entity's benefit stream since technically, such an entity does not pay tax.

The QBI deduction is basically 20% of the net income from a pass-through entity or sole proprietorship. However, the QBI relative to certain service industries (law, accounting, health, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services and those where the "primary asset of the business is the skill or reputation of owners or employees) starts to be phased out when the taxable income of the taxpayer reaches $315,000 (MFJ) or $157,500 for other taxpayers. A morass of limitations apply to the amount of the allowable deduction.

Another aspect of QBI relative to business valuation is that if a business classifies itself as NOT a specified service business, could that impair the ability of the owner or the appraiser to allocate portions of goodwill to the personal goodwill of the working owner or affect the value of workforce in place?

-Expanded use of cash method of accounting

Under prior law, business entities that had average annual gross receipts of $5 million or more were required to use the accrual basis of account (i.e. accrue receivables and payable, keep inventories where the production, purchase, or sale of merchandise is a material income producing factor to the business). This threshold has been increased to average annual gross receipts of $25 million. The cash basis of accounting contemplates recognizing expenses when paid and income when received, so the possibility for a mis-matching of income and expenses exists in the use of this method. The informational value of cash basis financials is limited compared to accrual basis financials. A business appraiser prefers the latter, especially because cash basis financials typically do not involve the accrual of receivables or payables. Therefore, to the extent businesses convert to all cash basis financial statements, those business will be more difficult to value. However, as a matter of course and necessity, many of these businesses will maintain accrual basis financials in order to track those items.

Also, businesses that were formerly required to keep inventories (which was any business where the production, purchase, or sale of merchandise is a material income producing factor to the business) and average annual gross receipts were less than $1 million, with certain exceptions). The threshold under TCJA is the same $25 million average annual gross receipts) and if the taxpayer is under that threshold, it may account for inventories as non-incidental materials or supplies or conform the method of inventory accounting to that used for financial accounting purposes.

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