NUTS AND BOLTS OF CHILD SUPPORT AND MAINTENANCE TAX LAW - 2019 UPDATE

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Lawyers who handle divorce cases must know the applicable tax law - especially regarding child support and maintenance. Divorce lawyers often refer clients to a tax professional such as an accountant or a tax lawyer. But that may not always ben enough for a lawyer to avert liability for malpractice. For example, the tax professional may provide the wrong advice, or the client may never obtain the recommended advice. In either of these circumstances, one California appellate court held that the lawyer could be sued for malpractice. Moreover, a knowledge of divorce tax law will allow you to help the parties save money through understanding the critical importance of the dual system regarding deductibility of maintenance that we now have depending on whether the divorce judgment was entered on or after January 1, 2019. I have found that in the average divorce case knowledge of the basics of tax law can often save your clients thousands of dollars a year.

I. **Federal Tax Considerations in Divorce Proceedings**:

A. **Maintenance/Alimony**:

Maintenance/alimony law radically changed in 2019. From the early 1940s through December 31, 2018, maintenance has been deductible to the party paying maintenance and has been ordinary income for the former spouse receiving maintenance. The mirror provisions have been in Sections 71 and 215 of the Internal Revenue Code (the "Code"). What this has meant is that maintenance has been deductible even if the payor does not itemize deductions. Child support, on the other hand, is not deductible by the payor.

In the 1980's Congress overhauled the Internal Revenue Code as it relates to taxation of maintenance. The basic principle - that the payor could deduct and the recipient must include the payments as income–had still remained good law. The Tax Reform Act of 1984 (TRA 84) and of 1986 (TRA 86) created several hoops that the family lawyer must jump through so that the payment would be considered alimony. The treatise that every lawyer who handles family law cases should have on the bookshelf is *Frumkes and Vertz on Divorce Taxation*, http://jamespublishing.com/shop/frumkes-on-divorce-taxation/ .

We still must know if maintenance is deductible–for divorce or written separation agreements entered into before January 1, 2019. For ease of reference, Frumkes used the pneumonic divorce of referring to the basic rules as "the 7 D's." They have been:

1. **Dollars** - Cash received by or on behalf of a spouse in the taxable year
2. **Documents** - Received under a divorce or separation instrument
3. **Designation** - The payments must not be designated as *not* includible in gross income under §71 and not allowable as a deduction under § 215. (I think of this as the "private ordering" exception).
4. **Different Households** (**Distance**) - If there is a divorce (or legal separation) decree, the parties must not be members of the same household when the payments are made.
5. **Death** - The payments must cease on the death of the recipient.
6. **Dependents** - The payments must not be fixed as child support.
7. **Dumping** - The maintenance payments cannot be front-loaded in excess of the permissible amounts or there will be recomputation in the third post-separation year.

1. **Dollars**

Payments Must be in Cash from One Spouse to the Other:

No deduction is allowed for a payment in services or property other than cash. For example, no deduction is allowed for a transfer in the form of a debt instrument. But this does not totally eliminate the provision of economic benefits to a spouse as qualifying maintenance payments.

Payments for the Benefit of the Recipient Spouse May be Maintenance:

Examples are rent, mortgage, tax, and tuition payments. As long as the benefit provided is readily and clearly calculable in dollars and are required by the agreement, this should qualify as maintenance. See A-6 of "Temporary Regulations" 1.71 IT. The exception here is that payments to maintain property owned by the payor spouse but used by the recipient spouse (such as mortgage payments, real estate tax payments and insurance premiums) are not payments made on behalf of a spouse. So, if you still own it, you can't deduct it.

Payment of Mortgage on Jointly Owned Residence:

> The more common scenario is one in which the payor is required to pay installments on the mortgage encumbering the marital residence which is jointly owned by the parties. The payor can deduct only half as a payment to a third party benefitting the payee who owns half the property. The payor, however, can deduct interest assuming the residence is his principal residence (or qualifying second residence under IRS §163.) The rules on payments on a marital residence are thus:
>
> > **Payor Holds 100% of Title**: Payor can only deduct interest portion so long as the recipient's occupancy is pursuant to a divorce or separation instrument.
> >
> > **Payor Holds Joint Interest**: Half the payments are deductible maintenance and interest can be deducted on the other half (with the above proviso).
> >
> > **Payor Holds no Interest**: The entire payment may be deductible alimony. The recipient can deduct interest – unless the payor also has occupancy.

2. **<u>Documents - Payments Must Be Made under a Divorce or Separation Instrument</u>**:

This includes written separation agreement, a temporary order for support, a Judgment of Dissolution of Marriage or a legal separation judgment. Retroactive instruments are not allowed.

The term "written separation agreement" is not defined in the Code. An interesting tax and illustrative court case is *Benham v. Commissioner*, T.C. Memo 2000-165. The husband paid $2000 per month to the wife under a temporary agreement. During this time period, the parties lived together in the marital residence while they were trying to reconcile. The I.R.S. disallowed the deduction, but the tax court ruled that the parties did not need to separate to have a qualifying written separation agreement. The Tax Court stated:

> A written separation agreement is a clear, written statement of the terms of support for separated parties. It must be a writing that constitutes an agreement. An agreement requires mutual assent or a meeting of the mind. But a written agreement does not have to be legally enforceable. It is sufficient that it was entered "in

> contemplation of a separation status" and includes a statement of the terms of support.

A divorce or separation agreement includes a typical letter agreement meant to cover only "temporary support." In one tax court case, the court determined that a letter from the husband's attorney to the wife constituted a written separation agreement and that the payments made were deductible alimony. A payment made by one spouse to another by way of an informal arrangement or oral agreement does not qualify. The best practice is to enter a temporary order of support which is not characterized as a divorce or separation agreement because of recapture rules. (See below for the recapture rule).

A court order for temporary maintenance may order a single lump sum to be paid and the order may reserve the right to order future lump-sum maintenance payments. These payments are deductible as maintenance and may include moving expenses and legal fees.

In *Johnson v. Commissioner*, T.C. Memo 2006-116, although the Wife was given exclusive possession of the marital home and the Husband was ordered to make the mortgage payments, there was no specific order to pay for homeowner's insurance. Therefore, it was not deductible alimony. The tax court explained:

> A taxpayer may not deduct specific payments as alimony absent a divorce or separation instrument requiring such payments. Petitioner invites us to read a command into the order *pendente lite* that is not contained in the order. While we agree that a prudent homeowner might purchase insurance to protect his residence, that does not automatically qualify the homeowner's insurance payments as deductible alimony expenses. Because the order *pendente lite* did not expressly direct petitioner to make homeowner's insurance payments, we hold that petitioner may not deduct the payments as alimony.

The court in *Katchmeric v. Comm.*, T.C. Summ. Op. 2007-213, ruled that the Husband's notation on a check, stating "support," does not show that he agreed to provide support under a written separation agreement, and thus is insufficient to qualify as alimony.

And keep in mind that we are addressing only divorce or written separation agreements entered before January 1, 2019. Before that date older judgments are "grandfathered" in and the payments for the duration should remain deductible (to the payor) and includable (to the recipient).

There were a number of written separation agreements entered into prior to the year end 2018 in order to provide for deductible alimony. There is little doubt that we will see tax court cases addressing this situation.

3. **Designation - "The Private Ordering" Provision**:

Payments are deductible unless they have been designated in the divorce or separation instrument as not taxable/deductible.

In *Goldman v. Commissioner*, 112 T.Ct., No. 21 (1999), affirmed in *Shutter v. Commissioner*, 242 F.3d 390 (10th Cir. 2000), the tax court held that the following language of a marital settlement agreement was a clear, explicit and express direction that the payments are not be included in the wife's income:

> The parties intend and agree that all payments of property as provided herein [periodic payments of $20,000 per month for 240 months] are subject to the provisions of Section 1041...and they shall be accounted for and reported on his or her respective individual tax returns in such a manner that no gain or loss shall be recognized as a result of the division and transfer of property as provided for herein. Each party shall file his or her Federal and State tax returns, and report his or her income and losses thereon, consistent with the foregoing intent of reporting the division and transfer of property as a nontaxable event.

The reason that there may have even been an issue in this case is that it did not use the preferred approach of mentioning Sections 71 and 215 of the Code (re deductions for maintenance and including maintenance as income). The *Goldman* court stated that, "we believe the divorce or separation instrument need not mimic the statutory language of the subparagraph. Rather, in our opinion, the divorce or separation instrument contains nonalimony designation [private ordering] if the substance of such a designation is reflected in the instrument." Frumkes comments:

> Because the *Goldman* court dwelled on the distinction between the division of assets and spousal support, if a stream of payments is for property and meets all other criteria of I.R.C. § 71, and is intended by the parties to, in fact, be taxable to the payee and deductible to the payor, it will be helpful to insert language expressing exactly what is meant and to state that the parties did not in any way intend that such stream of payments is designated as not taxable and not deductible.

Perhaps more interesting in terms of raising a warning flag is the case of *Baker v. Commissioner*, T.C. memo 2000-65. In the MSA, the parties agreed that the payments were for a property settlement, but payments were found to be alimony.

The agreement provided under the property settlement heading that the husband was to pay to the wife 50% of his monthly gross military retirement pay each month "as a property settlement until such time as she remarries or cohabits with another person or until her death." The tax court stated that the labeling of the payments as a property settlement with nothing more was not a "clear, explicit and express direction that the payments are not includible in the wife's gross income and not deductible by the husband. The key quote that serves as a warning to sloppy drafting states:

> If the payments fit within the definition of alimony for federal income tax purposes, the intended purposes of the payments is of no consequence. Thus, we find that the parties' intent in this case, except as reflected in the divorce or separation instrument itself is moot... The instrument must contain a clear, explicit and express direction that the payments are not to be treated as income.

Note that the parties can provide for private ordering in a temporary support order.

4. **<u>Distance / Difference Households - The Parties Must Live in Separate Residences</u>**:

Parties must reside in separate "households" after the entry of the final decree. The test is whether the spouses are still living under the same "roof".

5. **<u>Death - Payments Must Terminate upon Payee's Death</u>**:

It had not been is not necessary in Illinois to state in the Marital Settlement Agreement that the payments terminate upon death because the Illinois law provides maintenance is automatically terminable upon death. (See Section 504 of the Illinois Marriage and Dissolution of Marriage Act). If there is a provision for maintenance in gross (lump-sum maintenance payments which are intended to be deductible), the provision should read that it terminates on the death of the recipient. A 1999 tax court decision discussed other payment of tuition as a type of maintenance payments. An express termination on death provision was not required because of the nature of the payments - they were dependent upon the recipient attending school. Keep in mind that the termination on death requirement affects all payments. If the payments do not terminate on death, then none of the payments are deductible.

This brings up a related matter in Marital Settlement Agreements. Case law has held that where a Marital Settlement Agreement states that the payments are terminable upon death or wife's remarriage, this does not include conjugal cohabitation.

Failing to expressly state that payments will terminate upon death of the recipient does not automatically preclude the treatment of the payment as maintenance. In cases where the agreement or order is unclear, the IRS or tax court will consider state law in determining whether the payments would end on the recipient's death.

Further, there is no requirement that the payments terminate on the death of the payor. In fact, payments may continue or there may be substitute payments upon the death of the payor without jeopardizing the tax treatment of the alimony payment.

6. **Dependents - Contingencies Related to a Child**:

The payments may not be fixed as child support. IRC, §71(c). Payments will be treated as child support if a reduction in maintenance payment is made upon the happening of a contingency related to a child, such as the child attaining a specified age, marrying, dying or leaving school or a reduction is made "at a time which can clearly be associated with a contingency related to a child." According to the "temporary" regulations, payments are **presumed** to be reduced at times clearly associated with a contingency related to a child in two situations. In any other situation, a reduction would not be treated as not clearly associated with a child. Temp. Reg. §1.71-1T(c), Q-18. To be considered as maintenance, the payments must meet two tests:

a. **Single Reduction Test**: Payments are to be reduced not more than six months before or after the date the child is to attain the age of 18, 21 or the local age of majority.

b. **Multiple Reduction Test**: Payments are to be reduced on two or more occasions which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive - and is the same age for each child. Temp. Reg. §1.71-1T(c), Q-18.

Frumkes' and Vertz treatise addresses two tax court cases in which maintenance terminated within the six month period. In each of these cases, maintenance treatment was upheld. Nevertheless, be careful in any case where you have a termination date for maintenance at a time six months before or after a child turns 18 years of age. He also gives a series of tips to try to ensure deductibility. His rules are:

1. In negotiations of the length of payment, never mention the child's age.
2. Don't even discuss the children - especially their ages.

3. Keep all negotiation notes, letters and drafts of agreements.
4. Set forth what was intended by the parties as to taxation of payments.
5. Set forth the reasons for the time chosen for the termination of maintenance.

7. **Dumping - The Three Year Recapture Rule**:

TRA 84 complicated the taxation of maintenance payments by providing for a 6 year minimum term rule and a six year recapture rule. The current three year recapture rule is more simple.

Recomputation takes place at the end of the third post-separation year. Temporary support payments are not included. The recomputation results in the amount being added back to the income of the payor at the end of the third post-separation year with a windfall to the recipient because the amount would be subtracted from her income.

Maintenance provisions should be drafted to avoid the impact of these recomputation rules. There are two ways to avoid recapture:

One way of doing so is to start payments at the end of the first calendar year because the recomputation rules apply only on a post-separation year. Thus, the initial year's payments can be higher and level off over the remaining two calendar years. For example it is permissible to make payments as follows:

$50,000	December 31, 2018 (the last such year this has been possible)
$35,000	January 1, 2019
$35,000	January 1, 2020

Second, payments may decline by $15,000 or less in each of the 3 years without recomputation (safe harbor amount).

It is important to note that if maintenance is terminated before the end of the 3 year period, there may be a possible unforeseen recapture. In such a case it is best to state that maintenance is non-modifiable. If maintenance is modifiable, the lawyer should consider a recomputation clause where maintenance is over $15,000 per year.

The 3 year recapture provision revives the use of short term alimony and makes it possible to front-end-load within reason. Front end loading is generally referred to as a method to allocate property as short term maintenance with the attending tax benefits.

B. **Joint Income Tax Returns**:

The key exception to the above rules regarding deductibility of maintenance payments is that if the parties file a joint income tax return, there can be no application of Section 71 of the code. If you represent the less monied spouse, you can argue in favor of "private ordering" of maintenance by urging that the parties will likely save money by a joint filing and that you do not want to provide an incentive for a party to "dissipate" assets by failing to submit joint tax returns. An excellent discussion from *Frumkes on Divorce Taxation* addresses clauses that attempt to portray something as maintenance with the argument that they should then be tax deductible. The discussion from Frumkes states:

In *Fields v. Commissioner*, T.C. Memo. 2008-2007, Mr. Fields was required under Paragraph 4(a) of the Marital Settlement Agreement to pay Mrs. Fields $75,000 a year until December 31, 2001. Thereafter, so long as deferred payments provided in Paragraph 15(b) remain unpaid, he shall pay wife $50,000 a year. These amounts would cease on wife's death.

The deferred payments to the wife were delineated in paragraph 15 of the Marital Settlement Agreement as "Lump Sum" of $2,000,000 in delineated installments.

Paragraph 15(b) of the Marital Settlement Agreement contained the following provisions:

> All payments to the Wife under this paragraph are tax free to her and are not modifiable. The Husband expressly agrees that for the purpose of incorporation into a court order, the obligations set forth in Paragraph 15(b) above arise out of and are in the nature of support obligations and thus shall not be dischargeable in bankruptcy. The Husband expressly agrees that he shall not seeks to discharge or release any of these obligations in bankruptcy or any other similar obligations in bankruptcy or any other similar proceeding. The Husband further agrees that in the event he files for bankruptcy and is relieved of any of his obligations under paragraph 15(b), then the Wife shall have the right to petition a court of competent jurisdiction to receive an award of spousal support in an amount not to exceed the amount of the discharged Deferred Payments referred to in Paragraph 15(b).

Paragraph 25 of the Marital Settlement Agreement reads:

> The Parties intend, understand and agree that all transfers of property and Deferred Payments pursuant to Paragraph 15 above (excluding

> alimony payments) made to the Wife pursuant to this Agreement are intended to be tax free to the Wife, pursuant to Section 1041 of the Internal Revenue code, or under any other sections of the Internal Revenue Code which may pertain to said transfers or payments; provided, however, that the Wife shall be solely responsible for any taxes she may incur if she subsequently sells, transfers or otherwise disposes of the property and payments she receives pursuant to this Agreement.

There was no question that the amounts payable as "alimony" to the wife in Paragraph 4 of the Marital Settlement Agreement were taxable/deductible.

As to the payments due under Paragraph 15 of the Marital Settlement Agreement, the Tax Court gave little or no consideration to the husband's argument that since a divorce or separation agreement must specifically provide that the "payments are not includable in the gross income under [§71 IRC] and not allowed as a deduction under §215 IRC," they are not disqualified as deductible alimony, stating that "the divorce or separation instrument need not mimic the language of §71(b)(1)(B)."

The court also disregarded the use of the phrases "are in the nature of support obligation" and "spousal support" in the bankruptcy immunization clause in Paragraph 15 of the Marital Settlement Agreement.

Frumkes was correct, “The Bankruptcy clause is a good one.”

Does the Recipient Need to Pay Estimated Taxes on Alimony?

Divorce lawyers often like to take refuge in the fact that almost all are not CPAs. But there is certain basic information that we need to provide to our clients receiving maintenance. They often overlook in the first year setting aside funds to pay the tax due on the maintenance. Alimony is not subject to withholding. So, the one receiving maintenance should pay estimated taxes. Generally 90% of the annual tax liability is to be paid by estimated payments. Each quarterly payment should cover about one quarter of the total of the estimated taxes. And a penalty is imposed if the alimony recipient does not make the proper estimated payments. The IRS cautions divorced taxpayers:

> If you do not pay enough tax either through withholding or by making estimated tax payments, you will have an underpayment of estimated tax and you may have to pay a penalty. If you do not pay enough tax by the due date of each payment, you may have to pay a penalty even if you are due a refund when you file your tax return.

What About the Payor's Deductability – Is the Payor Able to Deduct Payments Even if Not Itemizing?

This is where we learn the term "above the line deduction." Alimony is deductible in determining the AGI as we can see by the basic net income chart. It is deducible even if the payor does not itemize.

Credits are Better Than Deductions

A tax credit is worth substantial more than a deduction in the same amounts. A tax deduction reduces your *taxable income*. Your tax is determined by applying your marginal tax rate against your taxable income. Therefore, if you are in the 25% marginal tax bracket and receive a deduction of $1,000, your tax obligation would be reduced by $250.

A credit reduces your *tax*. If you were in the 25% tax bracket and received a credit of $1,000, your tax obligation would be reduced by $1,000. Therefore, a credit is worth several times more than a deduction. Though a tax credit is always better than a deduction in the same amount, the tax credit is much more beneficial at lower brackets (at the 10% bracket, a credit is worth 10 times more than a deduction while at the 33% tax bracket a credit is only worth 3 times more than a deduction).

Dependency Exemptions

We include the discussion regarding dependency exemptions because it being able to claim the under age 17 child tax credit "follows" the right to claim the dependency exemptions. The value of the exemption for the years 2018 through 2025 is zero but there is a significant value regarding the under 17 child tax credit. 26 USC 152 defines a qualifying child or qualifying relative. In order to be a qualifying child, the child must meet four primary tests:

1. **Relationship Test**: The child must be a child of the taxpayer or a descendant of a child of the taxpayer or a brother, sister, stepbrother, stepsister or descendant of such a relative.

2. **Residence Test**: The child must have the same principal abode as the taxpayer for more than one-half of the year.

3. **Age Test**: The child must be less than 19 at the end of the tax year. A child can still qualify if older 19 but less than 24 at the end of the year, and is also a student.

4. **Support Test**: The child must not have provided more than one-half of the support for such child during the tax year.

Regarding divorced parties, the statute provides that if both parties attempt to claim the dependency exemption, the exemption will be awarded to the party with whom the child resided for more than one-half of the year. If the child lived the same amount of time with each parent, then the dependency exemption will be awarded to the party with the highest adjusted gross income.

The I.R.C. also has an exception to the ordinary rules regarding the dependency exemption that has allowed the non-residential parent to claim the exemption even if the child did not reside with that parent for more than one-half of the year. For the exception to apply, the parties must be divorced or legally separated by a decree, separated under a written separation agreement, or lived apart for all of the last six months of the tax year and the child was in the custody of one or both parents for more than one-half of the year. Should these provisions be met, the non-residential parent has been entitled to claim the dependency exemption if the residential parent has released the exemption.

For the non-residential parent to claim the exemption, the residential parent must provide a release in a form determined by the Secretary (this has been a form 5338) and the non-residential parent has been required to attach the form to his tax return.

The rules regarding the dependency exemption for divorced individuals also have generally applied to the parties of parentage proceedings. Usually parties to parentage proceedings satisfy the requirement to have lived separately for the last six months of the tax year. Therefore, if there is a parentage and child support order allocating the dependency exemption, or if the residential parent agrees to release the exemption, the non-residential parent in most parentage cases has been able to claim the child as a dependent.

In order to claim the under age 17 child tax credit, the requirement has been that the taxpayer must claim the child as a dependent on the taxpayer's tax return.

In August 2008, the IRS issued final regulations regarding the allocation of the dependency exemption between divorced and separated parents when the child is temporarily absent from a parent's home see: http://www.irs.gov/irb/2008-33_IRB/ar06.html#d0e688

The IRS regulations provide that a child temporarily absent from a parent's home is treated as residing with the parent with whom the child would have resided that night. If the child is with neither parent for a night, then the night does not count for either parent.

The regulations also require the decree to specifically state the years to which it applies in order to use the decree in place of Form 8332. Further, the residential parent could revoke a release by providing written notice to the other parent.

The Child Tax Credit

Child tax credit vital statistics:

Value	$2,000 per qualifying child (starting in 2018)
Dependent Exemption no longer deductible under the Tax Cuts and Jobs Act (TCJA).	Must claim qualifying child as dependent Prior to the TCJA, the taxpayer who was eligible to claim the child's dependent exemption was also the one eligible to claim the CTC. In turn, the taxpayer and child had to meet several "tests" for the one to be considered the dependent of the other. The TCJA eliminates the dependent exemption itself, **but retains the definition of dependent to claim the CTC and other child- or dependent-related tax benefits**. For Child Tax Credit reform purposes, this will usually mean that the child must be related to the taxpayer in one of several ways (son, daughter, grandchild, etc.), must live in the taxpayer's home more than half the year, and must not provide more than half of his or her own support.
Maximum age	Under 17
Phase out	The phase outs have significantly increased.

Maximum phase out	• The beginning credit phaseout for the CTC increases to $200,000 ($400,000 for joint filers). The phaseout also applies to the new family tax credit.
Refundable	• In low income cases, the refundable portion of the credit is limited to $1,400. This amount will be adjusted for inflation after 2018. • The earned income threshold for the refundable credit is lowered to $2,500.
Qualifications	None, other than above

Through to 2017, the allocation of the child tax credit depended on the allocation of the dependent exemption. To claim the child tax credit, the taxpayer had to be able to claim the child as a dependent. Therefore, in years where the non-residential parent is allowed to claim the child as a dependent, the non-residential parent will also receive the child tax credit.

The child tax credit ends the year before the child turns 17. If the child turns 17 prior to the close of the tax year, the taxpayer cannot claim the child tax credit for that child.

The child tax credit is also partially refundable in certain cases. A refundable credit is a credit the taxpayer receives even if the taxpayer pays no tax.

Child and Dependent Care Credit

Child and dependent care credit remains intact with the TCJA 17. The statistics remain:

Value	35% up to $1,050 for one child and $2,100 for two or more children
Dependant Exemption	Not relevant
Maximum age	Under 13
Phase out	1% for each additional $2,000 of income over $15,000, but not lower than 20%
Maximum phase out	None

Refundable	No
Qualifications	Only employment related expenses allowed; Dollar-for-dollar reductions for employer-provided assistance; and Limited to earned income of taxpayer or spouse.

Unlike the child tax credit, the child and dependent care credit is always available to the residential parent. This credit is only available to the extent the taxpayer pays of certain employment-related expenses for the care of the qualifying child, including day care in the qualifying center, or babysitting, housekeeping, cooking, maid, and nanny expense when care is provided in the home.

The credit starts at 35% of qualifying expenses up to a maximum of $3,000 of qualifying expenses for one qualifying child and $6,000 of qualifying expenses for two or more children. The credit is reduced by 1% for every $2,000 of income in excess of $15,000. The credit has a floor of 20% and no other phase out provisions. Therefore, no matter how much the custodian earns, the custodian will receive a credit of 20% of qualifying expenses as stated above.

To be a qualifying child, the child must be under the age of 13 at the end of the tax year and must be able to be claimed as a dependent on the custodian's tax return. An exemption applies to divorce individuals who allows the residential parent to take this credit even if the non-residential parent claims the dependent exemption for the child.

Divorce decrees will often provide for a division of child care expenses between the parents. This tax credit should be considered when deciding the division of the child care expenses as the cost to the residential parent is significantly lower than the cost to the non-residential parent, who cannot claim this credit.

II. **Child Support**:

Child support has never been deductible by the payor not nor taxable to the recipient. Child support is defined as a payment which is fixed in the instrument as support for a child of the payor spouse. Through to December 31, 2018, it remains possible to draft an **unallocated maintenance** provision if the reduction is outside of 6 months before or after the child turns 18 or 21. To do so also provide explicitly for the termination of the maintenance obligation on the death of the payee (the maintenance recipient). See: *Frumkes on Divorce Taxation*: §3.7.4.3. Such unallocated provisions must be carefully drafted.

A. **Dependency Exemptions**:

Recall that the right to claim the child as a dependent exemption simply is set at zero value for the years 2018 through 2025. So, while there is no current value to the exemption itself, this issue should be negotiated should there again be a value to this.

The general rule has been that the "custodian" of the children is entitled to take the children as dependent exemptions. But if the custodian agrees that the non-residential parent may take the children as exemptions and agrees to sign an Internal Revenue form (Form 8332) so stating, the non-residential parent is entitled to claim the children.

Custodial Parent of Minor Children: Assume the MSA awards primary parenting time to the mother but the father has de facto custody due to an informal arrangement between the parties. Assume also that the MSA does not award the exemption to either parent and a potential new client asks about whether he may claim the under age 17 child tax credit.

To advise the client, understand that for the purpose of the dependency exemption, tax law did not define the custodial parent as the parent named in a divorce decree. The tax court in *Maher v. Commissioner*, T.C. Memo 2003-85, addressed this issue and made the following pronouncements:

> We look to where the child resided to determine which parent had physical custody for purposes of section 152(e)(1). Even if the custody decree grants physical custody to one parent, we have held that this parent is not entitled to a dependency exemption when the children did not live with this parent for most of the year.

Use of Form versus MSA or Other Agreement: Any family lawyer knows that there are cases where one parent will not agree to sign the dependency waiver. In this situation the practice tips are:

☞ Do not include a provision limiting the right to claim the exemption (and with it the under age 17 child tax credit) to being completely current in child support, i.e., a conditional grant.

- ☞ If there are two children by way of example, do not simply provide that the right to claim the under age 17 child tax credit (and the exemption if it has a value in future years) be divided. Indicate which parent will be entitled to claim which child and for which year.
- ☞ Include language in the MSA that the primary residential parent is waiving the right to claim the exemption (and with it the child tax credit) in certain years and agrees not to claim such child as a dependent in those years.

In *Boltinghouse v. Commissioner*, T.C. Memo 2003-134, the requirement for stating the years for which the non-custodian parent could take the exemption was surprisingly satisfied, as follows:

> The language of the agreement, which referred to the separate returns of petitioner and Ms. Rogers as well as to joint returns to be filed no later than 1991, indicates that the allocation of the dependency exemption deductions was to apply to all returns filed after the divorce had been finalized. Thus, although the agreement did not explicitly state each and every taxable year to which it was to apply, we find that it unambiguously stated that it was to apply to all future years, which is permissible.

The Court in *Boltinghouse* held that the lack of Social Security numbers did not invalidate an otherwise qualified form or substitute written declaration.

Requirement for Written Waiver: A court order alone is not sufficient for the nonresidential parent to be able to claim the exemption; you need the written waiver by the "custodial" parent. Besides trying to attach the MSA an out of state case suggests an approach to enforce this provision: *Hughes v. Hughes*, 594 N.E.2d 653 (Ohio Ap. Ct., 1991). The former wife who had refused to sign the necessary waiver was held in contempt and fined with leave to purge herself. The ex-husband was granted a judgment for the additional tax he was required to pay and his former wife was required to pay his attorneys' fees in the post-judgment enforcement proceedings.

Dependency Exemption – Modifiable or Not Modifiable: The most recent Illinois case addressing the issue of the dependency exemption is *IRMO Parr*, 345 Ill.App.3d 371 (4th Dist. 2003). This case holds that the trial court has discretion to allocate tax dependent exemption of child to non-custodial parent and order the custodial parent to sign a declaration that he or she will not claim the dependent exemption after it considers both parent's contribution to the actual cost of supporting the child. In that case the wife urged that the trial court improperly awarded her husband two of the three children as dependent exemptions. See also *IRMO Moore,* 307 Ill.App.3d 1041, (5th Dist. 1999) holding that a trial court may divide dependency tax exemptions between parents who are each paying approximately half the expenses for the children.

According to Illinois law the award of the dependency exemption is generally modifiable based upon a substantial change in circumstances.

The agreement or Judgment of Dissolution of Marriage should specify that the parties shall execute such I.R.S. forms as are required to effect the allocation of the dependency exemptions it becomes applicable and especially the child tax credit.

Under Age 17 Child Tax Credit in Parentage Cases: Does the same law that apply to divorce cases also apply to paternity cases? If a parent provided over one-half of the child's support, that parent can claim the dependency exemption – even the father in a paternity case. The question is, however, whether that individual can rely upon a waiver by the other parent, i.e., the signature of the Form 8332 (or document with similar information).

In *King v. Commissioner*, 121 T.C. No. 12 (2003), the tax court held that the special support test under I.R.C. § 152(e)(i) can apply to parents who have never married each other. It noted that:

> Section 152(e)(1) provides that the special support test applies to "parents" in three different situations. The statute specifically provides that the test applies not only to divorced and certain separated parents, but to parents "who live apart at all times during the last 6 months of the calendar year." There is no requirement in the statute that parents have married each other before the special support test can apply. Section 152(e)(1) applies to any parents, regardless of marital status, as long as they lived apart at all times for at least the last 6 months of the calendar year.

Understand that Tax Court Memorandum opinions ordinarily are limited to the case and although readily cited are supposed to have no value as precedent. Regarding this issue, track the proposed regulations. See: http://pub.bna.com/fl/14985603.pdf (May 2, 2007). Excerpts from these proposed regulations are attached.

B. Under Age 17 Child Tax Credit:

Internal Revenue Code (IRC) now provides a credit of $2,000 for each qualifying child under the age of 17. A qualifying child is a child whom the taxpayer can claim as a dependency exemption. To claim the credit the taxpayer must include the taxpayer identification number of each qualifying child. The child must be under age 17 for the entire year.

A common misunderstanding is there needs to be very little income for this credit to apply because it is a refundable credit. One needs to only have earned only at least $2,500 to qualify for this credit. It is refundable up to $1,400 per child meaning that That means if you qualify for the Child tax credit and it brings your tax liability (how much you owe) below zero, the IRS will still send you the remaining amount of the credit, up to $1,400.

C. **Child Care [Read Dependent Care] Credit**:

What we often call the child care credit is actually the dependent care credit. The maximum dependent care tax credit is $3,000 for one qualifying individual or $6,000 for two or more. That's not the amount of your credit. It's the amount of daycare expenses to which you can apply the percentage. If you spent $7,000 over the course of the year on care for your two children so that you can work, the credit only applies to the first $6,000.

The percentage of your credit ranges from 20 to 35 percent of what you spent on daycare, depending on your adjusted gross income. Although there is no limit on how much you can earn and still qualify, the percentage does decrease as your earnings increase. See IRS Publication 503.

To claim the credit the person must be the custodial parent. Therefore, I have seen a number of marital settlement agreements which mistakenly provide that the parties will equally divide the ability to claim the child care credit (since they are equally dividing the expenses.) The provisions in such agreements regarding the child care credit are nullity. It may also be appropriate to consider this credit when allocating responsibility for child care expenses though most judges give the tax effect short shrift.

D. **Educational Tax Credits**:

The American Opportunity Credit has significant value.. This benefit is phased out at $90,000 of income for a single person or head of household or $180,000 for a joint return.

American Opportunity Tax Credit: Educational expenses can be daunting. There has been significant pressure on both private and public colleges resulting in significant increases in the tuition and other costs of a post-high school education.

To assist parents and students with these expenses, the Federal Government enacted legislation for the Hope Credit. The Hope Credit was a tax credit of up to $2,000 per year for the first two years of an individual's college education. In 2009, the Hope Credit was modified and "temporarily" referred to as the American Opportunity Tax Credit. Originally, the American Opportunity Tax Credit was intended to apply only for the 2009 and 2010 tax years. But it was extended agin and again.

The American Opportunity Tax Credit represents a boon to parents with children in college and provides a far more generous credit than the original Hope Credit. While the Hope Credit only applied for *two* years, the American Opportunity Tax Credit applies to the first *four* years of post-high school education. The American Opportunity Tax Credit allows parents to claim a credit of up to $2,500 per year calculated based on 100% if the first $2,000 of qualified expenses and then 25% of the next $2,000 of qualified expenses. As a result, most people will qualify for a significantly higher credit faster under the American Opportunity Tax Credit.

The American Opportunity Tax Credit also expanded on the definition of qualified expenses. Now, in addition to tuition, fees and certain other expenses paid to the educational institution, the taxpayer can claim course materials (books and supplies). Even a computer can be a qualified expense if required as a condition of enrollment or attendance.

Some parents may not have enough taxable income to claim the entire American Opportunity Tax Credit. In that case, the American Opportunity Tax Credit has been made *partially* refundable. The credit is refundable up to 40% of the total available credit or $1,000. This means that even if the taxpayer has *no tax due*, the American Opportunity Tax Credit may still be applicable. If the taxpayer qualified for the American Opportunity Tax Credit, they may also qualify for other credits, some of which may be refundable. Where there are multiple credits and multiple refundable credits, the attorney should refer to the rules regarding the order of application to determine what portion, if any will actually be refundable to his or her client. These rules can be found in Publication 970.

When dividing educational expenses among divorcing parents, keep the educational credits in mind. If the intention is to equally divide $15,000 of educational expenses is the intent, but the credit is not accounted for, then one parent (the parent claiming the credit) will end up paying $5,000 out of pocket while the other parent will pay $7,500 out of pocket.

Lifetime Learning: The Lifetime Learning Credit is worth up to $2,000 per return.

Earned Income Credit: The earned income credit is available to certain low income individuals. The earned income credit is calculated based on the earned income of the taxpayer, the taxpayer's filing status, and how many children the taxpayer claim as a deduction.

Earned income includes wages, salaries, tips, other employee compensation and net earnings from self-employment. Earned income does not include maintenance, or other payments by the non-custodial spouse.

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IRS's Q&A re the American Opportunity Credit: See:

Q1. **Have there been any changes in the past few years to the tax credits for college expenses?**
A. Yes. The American opportunity tax credit, which expanded and renamed the already-existing Hope scholarship credit, can be claimed in tax-years 2009 through 2017 for expenses paid for tuition, certain fees and course materials for higher education.

Q2. **The Hope scholarship credit originally applied only to the first two years of college. Has that changed?**
A. Yes. The American opportunity tax credit can be claimed for expenses for the first four years of post-secondary education.

Q3. **How does the American opportunity tax credit differ from the Hope scholarship credit and Lifetime Learning credit?**
A. Unlike the other education tax credits, the American opportunity tax credit includes expenses for course-related books, supplies and equipment that are not necessarily paid to the educational institution. It also differs from the Hope scholarship credit because it allows the credit to be claimed for four years of post-secondary education instead of two.

Q4. **How much is the American opportunity tax credit worth?**

A. It is a tax credit of up to $2,500 of the cost of tuition, fees and course materials paid during the taxable year. Also, 40% of the credit (up to $1,000) is refundable. This means you can get it even if you owe no tax.

Q5. **What are qualified expenses for purposes of the education tax credits?**
A. In general, qualified expenses for the education tax credits include tuition and required fees for the enrollment or attendance at an eligible post-secondary educational institution. To be creditable, the expenses paid during a taxable year must relate to: (1) an academic period that begins in the same taxable year; or (2) an academic period that begins in the first three months of the following taxable year. See Publication 970, Tax Benefits for Education.

The following expenses do not qualify:

Room and board.
Transportation.
Insurance.
Medical expenses.
Student fees unless required as a condition of enrollment or attendance.
Same expenses paid with tax-free educational assistance.
Same expenses used for any other tax deduction, credit or educational benefit.

Q6. **What additional education expenses qualify for the American opportunity tax credit?**
A. For the American opportunity tax credit, qualified expenses have been expanded to include expenditures for course materials, as well as tuition and required fees. For this purpose, the term "course materials" means books, supplies and equipment needed for a course of study whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance. Some or all of these expenses will be recorded on Form 1098-T, Tuition Statement. The student should receive a Form 1098-T from the educational institution that the student attended. If the student does not receive a Form 1098-T, the student should contact the educational institution and request the form.

Q7. **Does an expenditure for a computer qualify for the American opportunity tax credit?**
A. Whether an expenditure for a computer qualifies for the credit depends on the facts. An expenditure for a computer would qualify for the credit if the computer is needed as a condition of enrollment or attendance at the educational institution.

Q8. **How is the American opportunity tax credit calculated?**
A. Taxpayers will receive a tax credit based on 100 percent of the first $2,000, plus 25 percent of the next $2,000, paid during the taxable year for tuition, fees and course materials.

Q9. **How will the American opportunity tax credit affect my income tax return?**
A. You will be able to reduce your tax liability by one dollar for each dollar of credit for which you're eligible. If the amount of the American opportunity tax credit for which you're eligible exceeds your tax liability, the excess will be refunded to you up to the lesser of 40 percent of the credit or $1,000.

Q10. **Who can claim the American opportunity tax credit?**
A. Generally, a taxpayer whose modified adjusted gross income is $80,000 or less ($160,000 or less for joint filers) can claim the credit for the qualified expenses of an eligible student. The credit is reduced if a taxpayer's modified adjusted gross income exceeds those amounts. A taxpayer whose modified adjusted gross income is greater than $90,000 ($180,000 for joint filers) cannot claim the credit.

Q11. What is "modified adjusted gross income" for the purpose of the American opportunity tax credit?
A. It is the taxpayer's adjusted gross income increased by foreign income that was excluded, and by income excluded from sources in Puerto Rico or certain U.S. possessions.

Q12. Who is an eligible student for the American opportunity tax credit?
A. For the American opportunity tax credit, an eligible student is a student who: (1) is enrolled in a program leading toward a degree, certificate or other recognized post-secondary educational credential; (2) has not completed the first four years of post-secondary education as of the beginning of the taxable year; (3) for at least one academic period is carrying at least ½ of the normal full-time work load for the course of study the student is pursuing; and (4) has not been convicted of a felony drug offense.

Q13. If a student was an undergraduate during the first part of the taxable year and became a graduate student that same year, will the student qualify for the American opportunity tax credit?
A. If a student has not completed the first four years of post-secondary education as of the beginning of the taxable year, and has not claimed the Hope scholarship credit and/or the American opportunity tax credit for more than four taxable years, the student can claim the American opportunity tax credit for qualified expenses paid during the entire taxable year.

Q14. I'm just beginning college this year. Can I claim the American opportunity tax credit for all four years I pay tuition?
A. Generally, yes. Under current law, the credit will be available through tax-year 2017.

Q15. How does a taxpayer claim an education tax credit?
A. A taxpayer claims an education tax credit by completing Form 8863, Education Credits, and attaching it to Form 1040 or 1040A.

Q16. Can I claim the tuition and fees tax deduction in addition to claiming the American opportunity tax credit?
A. No. You cannot claim the tuition and fees tax deduction in the same taxable year that you claim the American opportunity tax credit or the Lifetime Learning credit. You must choose between taking an education tax credit or taking the deduction for tuition and fees. You also cannot claim the tuition and fees tax deduction if anyone else claims the American opportunity tax credit or the Lifetime Learning credit for you in the same taxable year. A tax deduction of up to $4,000 can be claimed for qualified tuition and fees paid. Although the credit will usually result in greater tax savings, taxpayers should calculate both the tax credit and the deduction on

the tax return to see which is most beneficial. Often, tax software will automatically compare the tax result, from taking the education credit or taking the deduction, for you.

Q17. What is Form 1098-T, Tuition Statement, and who provides it?
A. Educational institutions are required to file a Form 1098-T, Tuition Statement, with the IRS and to provide a copy of the form to the student, for each enrolled student for whom there is a reportable transaction. A reportable transaction includes payments received, amounts billed or refunds made for tuition and related expenses. For the Form 1098-T to be accurately prepared, the educational institution must address boxes 8 and 9. Note that box 8 will be checked if the student was enrolled at least half-time, and box 9 will be checked if the student was enrolled as a graduate student. There are some exceptions where an educational institution is not required to file and provide the Form 1098-T. These exceptions include:

Courses for which no academic credit is offered, even if the student is otherwise enrolled in a degree program.
Nonresident alien students, unless the student requests the institution to file Form 1098-T.
Students whose tuition and related expenses are waived entirely or paid entirely with scholarships or grants.
Students whose tuition and related expenses are covered by a formal billing arrangement with the student's employer or a government agency such as the Department of Veterans Affairs or the Department of Defense.
Q18. How do I know if my school is an eligible institution?
A. A student can check with the educational institution. However, this link from the Department of Education, http://ope.ed.gov/accreditation/, shows all accredited schools. If your school is found using this link, then it is an eligible institution and you can claim the American opportunity tax credit.

Q19. Can F-1 Visa students claim the AOTC?
A. For most alien individuals present in the U.S. on an F-1 Student Visa, the answer is no. Generally speaking, the time spent by an alien individual studying in the U.S. on an F-1 Student Visa would not count toward determining whether he or she was a resident alien under the substantial presence test for federal tax purposes. Thus, if you are an alien individual with an F-1 Student Visa, you are probably a nonresident alien. In general, if you are a nonresident alien for any part of the year, you do not qualify for the AOTC.

However, your parents may qualify for the credit even if you are a nonresident alien student if they claim you as a dependent on their tax return. If you are a U.S. resident filing Form 1040, and your parents do not claim you as a dependant, and you meet all of the other requirements for the credit, you may qualify for the credit.

Q20. What if the student's return was incorrectly prepared and filed by a professional tax preparer?
A. The IRS urges you to choose a tax preparer wisely. You are legally responsible for what's on your tax return, even if it is prepared by someone else. For more information, read IRS' Tips for Choosing A Tax Return Preparer.

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