NUTS AND BOLTS OF CHILD SUPPORT AND MAINTENANCE TAX LAW - 2018 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 will 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 will radically change in 2019. From the 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 is 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 may deduct and the recipient must include the payments as income -- is still good law. The Tax Reform Act of 1984 (TRA 84) and of 1986 (TRA 86) created several hoops that the matrimonial lawyer must jump through so that the payment will 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/ .

Divorce Taxation presents a host of practical ways that you can help your clients in divorce cases. Why learn the basic rules regarding deductibility of maintenance? By doing so, we will learn practical divorce-tax issues including:

1. What occurs when the husband is ordered to pay the mortgage on the jointly owned residence? Can there be a maintenance deduction?

2. What about the payment of other expenses such as food, or payment of the utilities? Are these considered as tax deductible maintenance even if not specified in a temporary order?

3. What if I want to provide for lump-sum property settlement, that is, a non-modifiable stream of payments paid for a certain period? Will just calling this a property settlement ensure that the recipient pays no taxes on the funds received?

4. Is it necessary that there be a court order in order for temporary maintenance to be deductible? What if there is an exchange of letters which clearly states the agreement to pay for maintenance? These letters would not be legally enforceable. Are the payments deductible maintenance?

5. Can you pay tax deductible maintenance in a lump-sum amount as a temporary order to pay for such items as attorney's fees?

6. Do the spouses have to live in separate households to obtain a deduction for temporary maintenance?

Neither the term maintenance, or alimony label in an agreement or decree is necessary. As *Divorce Taxation* points out, "The stream of payments can even be labeled as "property division" yet be deducted/taxable as alimony under Federal law (and state laws that apply the Federal criteria) if the requirements of I.R.C. §71 are met." But Frumkes provides the caveat that if a property stream is to be deductible, a key is that the death provision (the payments stop on death of the recipient) be explicit.

For ease of reference, Frumkes use the pneumonic divorce of referring to the basic rules as "the 7 D's." They are:

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. **<u>Dollars</u>**

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.

Temporary Payments that Benefit The Recipient:

At temporary support hearings, courts will often award a specific cash amount for food, clothing and other cash requirements. Such orders will often provide that the payor must continue to make payments for other expenses of running a household such as payment of rent, utilities, and local phone expenses. This *may* qualify as cash payments of alimony or separate maintenance. If the payments benefit the other spouse and are made under a divorce or separation instrument (usually a temporary order), the payments will be deductible maintenance. This was the holding by the tax court in *Simpson v. Commissioner*, T.C. Memo 1999-251. In this tax court case, the utilities were listed in the husband's name, not the wife's. Nevertheless, the required utility payments under a temporary order were held to be alimony because the wife and children were the only members of the household, "so she and the family were the beneficiaries of the payments." This is one reason it is critically important to be aware of how such temporary orders are negotiated - in terms of the language to be included in the order or agreement. Assume a payment for the utilities, but the husband's name is on the statements.

One of the questions above was whether you can provide for a lump-sum payment shortly before the divorce as a temporary order that will qualify as maintenance. Relatively recently, it was determined that lump sum payment under a temporary order to be paid before the entry of a Final Judgment were taxable/deductible, because if the recipient spouse died before the Final Judgment, the case (a Florida divorce) would abate. *Cleland v. Commissioner*, T.C. Summary Opinion 2009-60.

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.

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

Payments are deductible unless they are 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. **Distance / Difference Households - The Parties Must Live in Separate Residences**:

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".

This is not applicable in two circumstances:

a. If spouses prepare to separate and actually do so within 1 month of payment in question.

b. Orders for temporary maintenance.

5. **Death - Payments Must Terminate upon Payee's Death**:

It 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’ treatise addresses two recent 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
$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.

- **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

Dependents are define by 26 USC 152 as 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 will allow the non-custodial parent to claim the exemption even if the child did not reside with that parent for more than one-half of the year. In order 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-custodial parent can claim the dependency exemption if the custodial parent releases the exemption.

For the non-custodial parent to claim the exemption, the custodial parent must provide a release in a form determined by the Secretary and the non-custodial parent must attach that form to his or her tax return. Treasury regulation 1.152-4T has allowed an alternative mechanism if the custodial parent would not sign the dependency exemption. But since 2008, the exemption must be attached.

The rules regarding the dependency exemption for divorced individuals will also generally apply to parties of parentage proceedings. Usually parties to parentage proceedings satisfy the requirements to have lived separate 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 custodial parent agrees to release the exemption, the non-custodial parent in most parentage cases should be able to claim the child as a dependent.

Often the parties become bogged down fighting over the dependency exemption. When considering which party will receive the dependency exemption, the attorney also needs to consider the child tax credit. In order to claim the child tax credit, the taxpayer must claim the child as a dependent on the taxpayer's tax return. Therefore, presuming none of the phase outs apply, the total tax package should be considered.

The value of the dependency exemption depends on the marginal tax rate. At a marginal tax rate of 35%, the deduction of $3,400 (using 2007 numbers) would be worth $1,190. The total tax savings including the child tax credit would be $2,190. At the 10% marginal tax rate, the deduction would be worth $340. The total tax savings including the child tax credit would be $1,340. When the exemptions are allocated to the child support obligor, the obligor's tax obligation will go down, resulting in an increase in net income. The non-custodial parent should carefully consider whether they will actually be able to use the dependency exemption and the child tax credit in full before insisting on claiming the child as a deduction. Even where the additional child support due to the non-custodial parent's reduced tax does not completely offset the custodial parent's tax loss for releasing the exemption, so long as the obligor is in a higher tax bracket than the obligee, there will be an overall tax savings. This tax savings could be distributed in such a way that both parties benefit.

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 custodial 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 will 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**** [This needs to be updated.]

Child and dependent care credit vital statistics:

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 custodial parent, even in years where the custodial parent cannot claim the child as a dependent. 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.

In order 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 custodial parent to take this credit even if the non-custodial 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 custodial parent is significantly lower than the cost to the non-custodial parent, who cannot claim this credit.

II. **Child Support**:

Child support is not deductible to the payor 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. It is 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**:

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

Custodial Parent of Minor Children: Assume the MSA awards custody 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 take the exemption. To advise the client, understand that for the purpose of the dependency exemption, tax law does 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.

Children Reaching Age 19: A settlement agreement will often refer to the ability of each parent to take the children as dependency exemptions, e.g., alternated. But what happens once a child reaches age 19 (by year end)? For the child who has reached age 19, the dependency exemption may be taken by the parent who provides over half of that child's support if the child is a student not yet attaining the age of 24 at the close of the calendar year. For children who turn 18 during the year, the rule becomes more complicated and depends on when during the year the child turned 18.

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 to being 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 children as dependent exemptions will be divided. Indicate which parent will be entitled to claim which child and for which year.
- ☞ Include language in the MSA that the custodial parent is waiving the exemption 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 noncustodial 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, 280 Ill.Dec. 468, 802 N.E.2d 393 (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, (5^{th} 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.

Value of the Exemption and the Personal Exemption Phase Out: The value of the personal exemption for 2016 is $4,050. But once again there is a phase out in high income levels. What this means is that once income goes past certain benchmarks the benefit to the exemption is phased out and at some point there is no benefit to being awarded an exemption.

Filing Status 2016	AGI	AGI (Phase out complete)
Single	$259,400	$381,900
Married, Joint	$311,300	$433,800

Value of exemption depends on the tax bracket:

Tax Rate	Value of Exemptions	Under Age 17 Child Tax Credit
10%	$390	$1,000
15%	$585	$1,000
25%	$975	$1,000 (phase out begins)
28%	Max of $1,092	Phase out applies

33%	Max of $1,287 (Phase out may apply to bracket)	0 (Phased out)
35%	Max of $1,365 (Phase out applies)	0 (Phased out)
39.6%	$1,544	Phase out applies

Note, however, in the chart we are comparing apples and oranges, somewhat because the phase out is based upon the adjusted gross income, not the taxable income as in the tax tables.

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.

Dependency Exemption 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**:

Section 24 of the Internal Revenue Code (IRC) now provides a credit of $1,000 (for 5 years) 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. The current version extends the earned income formula for determining the refundable child credit, with the earned income threshold of $3,000 for two years, through 2017.

A "phase out" provision reduces the available credit as the taxpayer's adjusted gross income increases above $110,000 for married taxpayers filing joint tax returns; $75,000 for taxpayers filing as individuals or heads of household. The phase out is $50 for each $1,000 of adjusted gross income in excess of the threshold amount. The greater the number of children, the longer it will take to phase out the child tax credit.

The decision of the court in allocating the children as a dependent exemption becomes more complicated with the under age 17 child tax credit due to the lower phase out provisions. It will make sense to definitely award the exemption to the non-custodian when:

A. Custodial parent makes less than $20,000 and cannot fully use the child tax credit and non-custodian is in a higher tax bracket;

B. Custodial parent is in 15% tax bracket (she earns more than $20,000 but less than $45,000) and non-custodial parent has an AGI of less than $75,000 (except if remarried)

C. As general rule, the non-custodial parent should be in the higher tax bracket but also have an AGI of less than $75,000.

Example: Custodial parent is in 15% bracket but the non-custodial parent has an AGI of $110,000.

Benefit	**Dep. Exem.**		**Tax Credit**	**Net**
Benefit to Non-custodial parent:	$900	+	0	= $900
Benefit to Custodial parent:	$450	+	600	= $1,050.

There is a provision for a **refundable** credit for families with three or more children under age 17.

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 $1,050 (35 percent of up to $3,000 of eligible expenses) if there is one qualifying individual, and $2,100 (35 percent of up to $6,000 of eligible expenses) if there are two or more qualifying individuals. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income ("AGI") above $15,000. Therefore, the credit percentage is reduced to 20 percent for taxpayers with AGI over $43,000. This credit was made permanent.

The **maximum** value of the child care credit is:

One Child Under Age 13	Two Children Under Age 13
$1,050	$2,100.

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. **<u>Educational Tax Credits</u>**:

There are two educational tax credits benefits that also rely on the dependency exemptions: the Hope Credit and the American Opportunity Credit. The critical issue to remember is that regardless of who pays for the tuition (whether it is paid by the student or either parent), the credit goes to the person claiming the dependency exemption. This benefit is phased out at $50,000 of income for a single person or head of household or $100,000 for a joint return.

<u>American Opportunity Tax Credit</u>: 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 in 2010 and again in 2013. It will continue in its current state until the 2017 tax year. Absent some action by Congress, the American Opportunity Credit will automatically cease starting in 2018 and the regular Hope Credit will again become available.

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.

There are also limitations on the taxpayer's ability to claim the American Opportunity Tax Credit. The phase-outs are:

	Modified AGI	
	Phase Out Begins	Complete Phase Out
Single	$80,000	$90,000
Joint	$160,000	$180,000.

These income limits are higher than under the now in hibernation Hope and the Lifetime Learning Credits**..**

So, if your client remains unmarried and has income (modified AGI) in excess of $90,000, the credit will have no value.

Combining various educational and tax benefits to pay for college can also make things a little trickier. If tax-free scholarships or tuition programs are being used to pay a portion of tuition or other qualified expenses, then those expenses will not be qualified expenses for purposes of the American Opportunity Tax Credit. When paying college expenses with a combination of sources, parents would be well-advised to use such tax-free funds for other expenses for which they can be used.

In contrast, *if* the Hope Credit returns in its unmodified form, the maximum credit will be $1,800, will apply to only two years, and will have significantly lower income phase-out limits.

But it seems unlikely the sunset clause on the American Opportunity Tax Credit would go into effect without some modification to the Hope Credit.

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.

This credit travels with the dependent exemption. This means that the parent who claims the child as a dependent exemption will be entitled to claim the credit, to the extent the law allows, regardless of who actually paid the educational expenses. The other parent would have no right to any part of the credit regardless of his or her contribution to the educational expenses of the children. Of course, the court cannot effectively divide the dependency exemption for the emancipated child under current IRS rules. Therefore, the parent who will be entitled to the educational credit will be determined by general IRS rules regarding allocation of the dependent exemption. However, the court should be able to consider who will get the credit and account for this in its allocation of expenses.

Lifetime Learning: The Lifetime Learning Credit is worth up to $1,000 for costs beyond the first two years on a per family basis. Generally, some portion of the first $5,000 of tuition expenses will apply for one credit or the other. The use of this credit is negated by the use of any tax free educational account funds.

If the modified AGI is between $52,000 and $62,000 (filing single) or between $107,000 and $127,000 (joint return) a client can claim the credit. If the modified AGI is more than $62,000 (filing single) or more than $127,000 (filing a joint return) one cannot claim an education credit.

So, from a tax planning perspective, for many high income families the credit is eliminated (phased out.) If the child has an income it may make sense for the child to take the exemption and eliminate his or her tax bill. But be careful that this does not jeopardize health insurance coverage or financial aid eligibility which may require a parent to claim the exemption.

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.

The maximum credit for 2013 is $3,250 for one qualifying child, $5,372 for two qualifying children, and $6,044 for three or more qualifying children. The credit increases as the taxpayer has more earned income until the credit begins to phase out. The IRS publishes tables showing the applicable earned income credit for each amount of earned income. The earned income credit is completely phased out when earned income or adjusted gross income exceeds $37,870 for one qualifying child, $43,038 for two qualifying children, and $46,227 for three or more qualifying children.

For a child to be a qualifying child for the earned income credit, the child must meet all the requirements to be claimed as a dependent by the taxpayer with exception that the child may provide more than half of his or her own support. If the taxpayer could claim the child as a dependent, then the child is a qualifying child even if the taxpayer releases the dependency exemption to the non-custodial parent.

It is possible to accidently prevent the former spouse who would otherwise qualify for the earned income credit for qualifying for the credit. When a spouse received alimony, that amount is included in the spouse's adjusted gross income. The phase out for the earned income credit looks both to the earned income of the taxpayer as well as the adjusted gross income of the taxpayer. Whichever is higher will determine the phase out. Therefore, taxable alimony could result in a loss of the earned income credit. In such a case, the parties should consider a non-taxable alimony award at a lower figure. This preserves the tax benefit of the earned income credit at the cost of the tax benefit of the alimony payment. The question the lawyer must address is which is more valuable.

As a practice tip, when you have a client who will have income low enough to qualify for the earned income credit and who may also receive maintenance in the divorce, you should use adequate financial planning software to determine the overall effect of maintenance. The goal, of course, is to provide the largest economic pie possible for the parties to divide when ensuring your client receives his or her fair share of the pie. The calculations of the earned income credit versus tax savings of alimony are complicated enough that hand calculations or quick calculations are likely to be erroneous. Comparative analysis software is the safest approach.

IRS Q&As are Am Opportunity Credit:

E. **Importance of Allocation of Dependency Exemption**:

I agree with the point that was made by Scott B. Frankin, C.P.A., J.D., in the Fall 2002 issue of the *Family Advocate* regarding the allocation of the dependency exemption. He stated:

> To adequately negotiate the dependency exemption, first prepare an estimate of the anticipated tax savings and potential child-tax credits, dependent care expense credits and educational tax credits which might result from claiming the exemption. The parent with the greater dollar benefit in terms of overall tax savings should claim the exemption, especially to encourage child support payments. If negotiations are a challenge, consider splitting the value of the exemption between the benefitting parent and the paying parent for some fraction of the savings; in this case, both parents will likely be better off in the end.

F. **<u>Low Income Divorce - Why Bother with Taxes?</u>**

1. In a low income divorce (one party makes under $25,000 and there are children), the general impression is that taxes are not important. This impression is very wrong especially when taxes are compared to the total gross cash of the parties. If you think tax savings of $2,500 per year matter to low income divorcing parties, this part of the presentation is for you.

2. The Illinois guidelines are based on after-tax income of the support payer so accurate taxes will result in appropriate Illinois child support. When tax calculations are not representative of the actual tax situation at the time of divorce or temporary order, child support will be understated and the children are hurt. There are many situations in which the error is much greater than would normally be expected.

   When taxes are "generally estimated" for a divorce (use a pay stub, apply Circular E tax tables to income etc), taxes will be higher resulting in decreased child support. Circular E uses slightly higher tax rates so the government uses our money and these simplified tax methodologies ignore tax credits. In a low income divorce, the various tax credits are very significant and must be computed correctly if the real after-tax situation of the parties is to be understood.

   While taxes are important in computing child support, taxes are also very critical in allowing the client to understand the real economic consequences of support. Let's look first at what the divorcing individual needs to know to make an informed decision on the support aspect of a divorce.

3. What does the client want to know to make an informed decision on support and prepare for life after divorce?

   Clients want to know how much **REAL CASH** they will have after divorce.

   a. In a program such as FinPlan this is called Cash to Meet Living Expenses.

      (1) It is all gross income less all taxes including taxes on alimony plus or minus support - It is what the client can spend and thus is **comparable to the budgets** prepared in divorce cases.

   b. Budgets (living costs) are based on after-tax figures.

c. You must **compute taxes to answer client's questions** on Real Cash.

d. In many cases, there is **not enough cash** to meet budget needs and clients should refocus on budgets and actual living costs - essential to give them after-tax figures so that they understand that Real Cash will be less than they thought and that they need to **reassess their budgets.**

e. If the "Real Cash" numbers are not presented to the divorcing individual, settlement of support issues can be difficult because the parties don't really understand how support numbers are going to impact their lives.

f. Essential to have a way to compute the REAL after-tax settlement numbers and compare this to budgets

g. Tax software such as FinPlan and Family Law Software will accurately computes the taxes and Illinois guideline support and shows how much real cash each party will have from the settlement of support.

h. You can use either package to illustrate the low income case. It is unfortunate and counter-intuitive, but the reality is that tax computations for the low income individual are more complicated than for many others. The reason is the various credits available to low income individuals are difficult to calculate is because some credits are refundable or partially refundable so these individuals can be receiving cash payments from the government even if they have a zero tax liability. Before the more recent changes to the Tax Code creating all of the credits, I could quickly and authoritatively use a spreadsheet to determine net income.

G. **Steps to Use for Determining Net Income**:

1. **Cash Facts**: Enter Case Facts

2. **Reports Showing After Tax Cash of Both Parties and Tax Reports**: Once the case facts are entered into computer, the program automatically prepares reports showing the after-tax cash of both parties and several reports on taxes.

III. **Further Details 2013 Changes Re Tax Law and Their Effect on Divorce Cases**:

When completing net income calculations, one key aspect to understand is the overall limitation on itemized deductions and the personal exemption phase-out.

Itemized Deductions: Start by looking at the limitation on itemized deductions, which is often referred to by its short-hand name of PEASE after the Congressman who originally developed it. This limitation was pulled out of the law between 2006 and 2010, but was resuscitated for 2013 by the fiscal cliff deal. Beginning this year, one must reduce his or her total itemized deductions by 3% of the excess of the adjusted gross income over the applicable threshold: $300,000 if married filing jointly, $250,000 for a single taxpayer, and $150,000 for married filing separately. (The limitation does not apply to deductions for medical expenses, investment interest, casualty and theft losses, or gambling losses.) If the adjusted gross income does not exceed the applicable threshold, your client is not impacted by the PEASE limitation. Knowledge of this impacts some divorce settlements in high wage earning cases.

To illustrate: In 2013, A and B earn $400,000 of adjusted gross income and pay $50,000 of total itemized deductions, comprised entirely of mortgage interest and real estate taxes. A and B file a joint return. With the return of the PEASE limitation, A and B are required to reduce their itemized deductions by 3% of the excess of their adjusted gross income ($400,000) over the applicable threshold ($300,000), or $100,000 *.03 = $3,000. Thus, A and B can deduct $47,000 of itemized deductions on their 2013 tax return.

The bottomline in relatively simple cases is that if you represent the recipient, you want to include as many itemized deductions as possible when working with your Family Law Software calculations.

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IRS's Q&A re the American Opportunity Credit: See:
http://www.irs.gov/uac/American-Opportunity-Tax-Credit:-Questions-and-Answers

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 for expenses paid for tuition, certain fees and course materials for higher education in 2009, 2010, 2011 and 2012.

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.*** 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.***

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. ***

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. ***

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.* ***

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