Tax Reform Plus One Year: What We Better Understand, Its Impact on Divorce and the New Tax Forms

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Over the last year, family law practitioners worked to understand how the Tax Cuts and Jobs Act (TCJA) affected personal tax consequences in divorce matters. In particular, the fallout from the alimony repeal and new support formula created new considerations in equitable distribution and net income available for support calculations. A host of other changes, from child tax credits and dependents to limits on deductions, have altered many of the basic tax guidelines that many of us know and rely upon. One tax filing year has passed since the historic and sweeping changes of the TCJA took effect. At last, we now fully appreciate the influence of these changes.

The purpose of this article is to review some of these changes, identify planning opportunities and other strategies, and to highlight what we've learned since the first implementation of the TCJA. We also examine some of the divorce related tax nuances as related to equitable distribution and support determinations.

Households and Family

Prior to TCJA, much of the negotiations to leverage tax rate differences between divorcing couples centered on deductible alimony and dependency exemptions. While the tax forms still require dependents to be reported, the dependency exemption amount has been reduced to zero through 2025. However, what remains important is the one entitled to claim the dependent because the parent claiming the dependent is also entitled to claim child tax credits and the other related education credits. As in the past, a custodial parent may surrender the dependency exemption by filing tax form 8332, which the non-custodial parent must attach to their tax return in order to claim the credits. Marital settlement agreements should still reference dependents but make particular reference to the temporary suspension of the deduction, reserving the right to the deduction to the earlier of a change in status or the expiration of these changes in year 2025.

The child tax credit is $2,000 per child for dependent children under age 17. Beginning in 2020 the full amount of the credit is available if modified adjusted gross income is under $400,000 for married filing jointly and $200,000 for all other filers. The credit has much greater value than a deduction and has been increased to benefit middle and higher income taxpayers.

The beneficial tax status, head of household, affords separate filers with qualified children numerous benefits aside from lower marginal tax rates. Since many lower- and middle-income filers no longer itemize their deductions, the benefit of the standard deduction cannot be underestimated. The head of household standard deduction, $18,350 for 2019 and $18,650 for 2020, is greater than 50% of the single filing status.

Capital Gains and Losses

In addressing capital gains and losses, practitioners must remember that there are three tax rates applicable to long-term capital gains. The difference in the rates (0%, 15% and 20%) can have a material impact on the tax result. In dividing assets subject to long-term gains, do not assume a flat rate of 15% or 20%. The chart below summarizes the rates and brackets.

Rate	Single Total Income	MFJ Total Income
0%	$0 to $40,000	$0 to $80,000
15%	$40,001 to $441,450	$80,001 to $496,600
20%	Over $441,450	Over $496,600

You may have to apply different tax rates on capital gains if your gains cross the above brackets. By way of example, if ordinary income is $350,000 and capital gains is $100,000 (single filer), then $91,450 of gain income (the amount that falls into the lower bracket) is taxed at 15% and $8,550 of gain income (the amount in the higher bracket) is taxed at 20%.

The TCJA incentivized investing in economically distressed communities, or areas deemed Qualified Opportunity Zones (QOZ), by delaying and possibly reducing capital gains tax payments. Capital gains, either short- or

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long-term, must be reinvested in Qualified Opportunity Funds (QOF) within 180 days of date of sale. Reinvested gains held for 7 years and made before 12/31/2019 are reduced by 15%. If the investment is held for 5 years and made before 12/31/2021, the taxable gain is reduced by 10%. If the investment is held for 10 years, the taxable gain is reduced by the percent previously mentioned and 100% of the additional appreciation from the new investment is non-taxable. Under the current law, the balance of the deferred gain must be recognized the earlier of the date of the sale of the property or the year 2026. The tax is applied to the balance of the gain (95% or 85%) at the end of either the 5- or 7-year holding period, respectively. Taxpayers can take advantage of the QOZ benefit and defer any short- or long-term capital gain as well as gains on sales of business properties. As a result, many QOZ funds have been established for investors to easily rollover gain proceeds. The chart below summarizes these options:

Investment/Action
Capital Gains (short- and long-term)/Invest in QOF Within 180 Days After Sale
Held in QOF for five Years (before 12/31/2021)/10% Tax Reduction on Reinvested Gains
Held in QOF for Seven Years (before 12/31/2019)/15% Tax Reduction on Reinvested Gains
Held in QOF for 10 Years/Applicable Tax Reduction AND 100% Tax Free Gain Appreciation on the new asset

By way of example, assume a stock purchase at a tax basis of $100,000 and then, one year later the sale for $300,000. The long-term capital gain is $200,000 ($300,000-$100,000) and subject to a 15%-20% capital gain tax (assume $40,000; $200,000 x 20%). One can opt to delay this $40,000 tax payment if the $200,000 gain is reinvested into a QOF or QOZ within six months of selling the stock. If the $200,000 gain remains invested in the QOZ for five years, the tax bill on this $200,000 is reduced by 10% (or $4,000; $40,000 x 10%). If it remains invested for seven years, the tax bill is reduced by 15% (or $6,000; $40,000 x 15%). If held for at least ten years and the QOZ properties appreciate so that the investment has grown to a total of $300,000, the tax is reduced by 15% ($6,000) and the $100,000 appreciation on the new asset is tax free.

The tax on the deferred gain is a marital liability that must be accounted for and valued as of the asset division date, though payable after 5 or 7 years. Conversely, for purposes of income available for support, consider the necessity of the rollover against whether such action deprives a spouse and/or children of support. This tax benefit investment decision is similar to a Section 1031 exchange where the gain from a sale of real estate is deferred into another real estate investment. However, the difference is that a Section 1031 exchange tax liability is unknown in amount and timing whereas the QOZ deferred tax liability amount and due date are known (assuming the law doesn't change).

Form 8949 is filed in the year of sale to report eligible gains invested in QOZs and includes the election to defer the gain. Look for new IRS form 8997 which is now required to track the deferred tax from a QOZ investment.

Pass Through Real Estate and Business Owners

There is little doubt that some of the more sweeping changes brought by the TCJA impact sole proprietorships, pass through businesses and real estate owners. When dividing these business assets in equitable distribution, be mindful that, for tax purposes, the sum of the parts does not always equal the whole. The Section 199A deduction may reduce the effective federal tax on sole proprietorships, pass through businesses, and real estate owners but has uneven results with complex restrictions. Some of the most significant changes are explained below:

1. Section 199A allows for up to a 20% deduction for qualified trade or business income. While the benefit of the deduction may be limited depending on the amount of income reported, at certain levels, the full 20% is allowed. For example, a Schedule E rental which generates $20,000 of taxable income may generate a $4,000 deduction. But additional elements must be considered. For example, is a single rental property a trade or business? Are properties owned by partnerships a trade or business? For these nuances, a safe harbor was provided that allows the full deduction if over 250 hours of services are spent in each year for the rental enterprise. Multiple properties can be aggregated to reach this threshold. But what happens when the properties are divided in divorce? Suddenly, one party may not qualify and lose the deduction while the other party may still benefit. In evaluating the after-tax income post-divorce, the involvement of each spouse in each business rental must be evaluated to determine correct net of tax cash flow. We have experienced errors by opposing experts in not considering

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application of this provision.

2. New tax form 8995 is now required to calculate and track the Section 199A deduction and carryovers. When reviewing tax returns in a year that income from pass through businesses and rentals are reported, the following items are either marital assets or will impact the tax outcome of the division of assets:

a) **Phase-outs.** Deduction for 199A is phased out at different thresholds. Consequently, income from certain service businesses and other pass through entities may qualify for the 20% deduction when married and not apply when separated.

b) **Aggregation of businesses.** To qualify for the Section 199A deduction taxpayers may elect to aggregate businesses. This will almost always apply when multiple real estate entities are owned. The same person or group of persons, either directly or indirectly, must own 50% or more of each trade or business to aggregate. In divorce, the issue of whether the remaining properties retained by the spouses can be aggregated must be explored.

c) **Loss carryovers.** Losses from businesses that could have qualified for the 20% deduction but instead, due to an overall loss in a particular year from the combined flow-through, must be carried over. This reduces the benefit of the 20% deduction. This carryover is a marital tax future cost (detriment) that will adversely impact the owner and must be accounted for when dividing assets.

3. A restriction on tax deductible interest expense (IRC Section 163(j)) received little fanfare until many practitioners began preparing extended returns for real estate and other business owners. This is an expense deferral provision which can have serious short-term implications and will apply to certain business and/or real estate investors. While, again, the rule is complex, the critical issue for equitable distribution is to identify the carryover which is reported on IRS Form 8990.

The most common candidates to have an issue under 163(j) are owners of medium to large businesses or groups of businesses whose aggregate gross receipts are $26 million or more. The current limit on deductible interest is based on a formula that over the next few years becomes more restrictive. In equitable distribution and for income available for support, the deferral of the deduction raises current taxes by the loss of the interest deduction. The taxes due are currently payable and the deferred interest may or may not be realized quickly. Besides the prepaid tax, which may or may not be later mitigated with the deferred deduction, the additional tax reduces income available for support.

4. Overall business loss limits have surprised many filers who are accustomed to assuming that business losses are fully allowable against all forms of income. Section 461(i) has altered this practice, capping annual business losses at $510,000. Once you pass the at-risk and passive loss benchmarks, this new cap restricts the loss allowed in the current year with the unused portion as a net operating loss in the succeeding year (further limited to 80%).

By way of example, assume a divorcing client suffers a $1,010,000 business loss in their operating S corporation and has capital gains and dividend income of $810,000. On their return, they will report a net of $300,000 in taxable income despite having lost $1,010,000 in their business. The unused loss of $500,000 is carried to the next year and can offset up to 80% of that years' taxable income. In equitable distribution, the excess loss is a marital asset similar to a passive loss carryover.

The 2019 Secure Act's Impact on Divorcing Couples

The Secure Act was passed Dec. 20, 2019 and contained some significant changes for divorcing couples. Most impactful, the required minimum distribution age has been raised from the longstanding 70 ½ years old to 72 years old – effective for individuals who attain the age of 70 ½ after Dec. 31, 2019. This allows more couples to defer taking the funds and allow further growth and tax deferral. This may hinder spouses seeking support due to the later requirement to withdraw funds that would have been available 1 ½ years earlier under the old rules. Some spouses, however, continue to work until the mandatory withdrawal date thereby increasing earned income available for support.

The Secure Act added a requirement that, beginning in 2021, plan administrators must forecast future income for all plan participants. This should be added to the discovery requests seeking information about retirement plans. The new rules apply to defined contribution plans as well.

The benefits of stretch IRA's have been curtailed by the Act such that any non-spouse beneficiaries must withdraw the entire plan interest within a 10-year period. As we all represent more and more Baby Boomers with

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inherited IRA's, the timing of the income taxes payment with an inherited IRA is now more definite. The consolidation of withdrawals into a 10 year period will create a bunching of income to beneficiaries increasing the tax bracket of the recipient and reducing the benefit on deferring the tax over a longer period of time.

Section 529 Plans have been enhanced to allow greater flexibility such that distributions may be made to reduce up to $10,000 of qualified education loans. These assets solve many divorcing couples' present and future education obligations by payments of up to $10,000 annually for secondary schools.

Tax Extenders and Medicare

The 2019 Tax Extenders bill retained the medical expense deduction threshold at 7.5% of adjusted gross income. For older couples who are divorcing with lower adjusted gross income, this deduction has a significant impact. Further, practitioners should be identifying larger HSA assets as marital assets. This is an asset for future medical expenses including paying disability premiums. We are experiencing many couples using the HSA as a "piggy bank" for future medical costs and paying current medical costs out of pocket.

Health insurance is a constant issue when couples divorce and one or both must now provide for themselves. As the cost of health care is discussed, the impact of the surcharge needs to be considered as well. We, as practitioners, must warn clients about the escalating Medicare participation required as income increases. There is a surcharge on Part B (doctors) and Part D (private plan) premiums. The surcharge is based on modified adjusted gross income two years prior to the year that the premiums are paid. For example, 2017 income is used to gauge the 2019 premium surcharge. The surcharge for Part B in 2019, at the lowest level, is $135.50 a month and, at its highest level, increases to $460.50 a month for income over $500,000. Roth retirement income and HSA withdrawals do not add to modified adjusted gross income. An appeal process is available to reduce the income upon which the surcharge is based; a divorce is a life changing event that qualifies for appeal. Such appeal should be undertaken to avoid unnecessary premium payments.

TCJA and year-end 2019 legislation brought many changes that we have taken time to understand and consider in income available for support and asset divisions. Taxes are a certainty and, as we know, paid each year. An oversight or failure to take advantage of the above can under or overstate assets for equitable distribution and lead to unnecessary future tax burdens.

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Supreme Court Issues Order Temporarily Modifying CLE Requirement

During 2020, all required CLE credits can be earned by distance learning education, according to a Supreme Court of Pennsylvania order issued on April 15. The PBA advocated with the Pa. Continuing Legal Education Board for this modification of the CLE requirement. Read the order at http://www.pacourts.us/assets/opinions/Supreme/out/Order%20Entered%20-%2010439644899571598.pdf?cb=1