TCJA MISCELLANY

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Ms. Epstein has authored numerous articles on tax and corporate matters for various legal publications and is a co-author of the CCH Federal Income Tax Service recently included in its tax internet service provided to tax professionals. She has been a member of the faculty of continuing legal education programs on various tax matters and has appeared to speak at the ABA Tax Section Conferences, Smeal College of Business of the Pennsylvania State University, the Annual Statewide Pennsylvania Liaison Working Together Conference, Pennsylvania Bar Institute, the National Business Institute, Young Lawyers' Division of the American Bar Association, Amnesty International, the New Hampshire Women's Bar Association, the 13th Annual Conference of Feminist Law Professors, Temple University's Beasley School of Law, and the Pennsylvania Bar Minority Bar Committee Conference.

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In 2010, Ms. Epstein was named as a Vision 2020 Ambassador to participate in a decade-long national project inspired by the 100th anniversary of the Nineteenth Amendment to the U.S. Constitution granting the right of suffrage to women. The goal of Vision 2020 is to move toward gender equality and to inspire new generations of leadership.

Ms. Epstein's practice is in tax planning, estate planning, and tax controversy matters before the IRS and in the Tax Court, trust and estate management, Orphan's Court litigation, corporate transactions, and elder law.

I. THE LOSS OF MISCELLANEOUS ITEMIZED DEDUCTIONS

The 2017 Tax Cuts and Jobs Act was signed into law on December 22, 2017. With the new law, all job expenses and miscellaneous itemized deductions which are reported by individuals on Schedule A of Form 1040—the individual federal income tax return—are suspended effective for tax years beginning January 1, 2018 and ending December 31, 2025. The suspension of these deductions was implemented by adding Code section 67(g) (2017 Tax Cuts and Jobs Act Section 11045(a)). Section (g) provides:

> Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.

The statutory basis for miscellaneous itemized deductions is set out in Section 67(a) of the Internal Revenue Code ("IRC") which provides as a general rule: "In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds two percent of adjusted gross income." IRC Section 67(b) carves out a list of deductions that are not subject to the two percent floor leaving all others not listed subject to the two percent of AGI limitation.[1] The deductions subject to the two percent limit are entered on Schedule A of Form 1040, lines 21-23. These deductions will no longer be available for individual taxpayers. What has been lost?

Unreimbursed Business Expenses

Generally, the deduction for employee business expenses includes, for example, unreimbursed employee expenses for job travel, union dues, and job education. The deduction for unreimbursed employee business expenses is entered on line 21 of Schedule A.

The instructions to Schedule A as well as IRS Publication 529 and IRS Temporary Regulation Section 1.67-1T shed light on the types of expenses that can be deducted provided they are unreimbursed, incurred in the current tax year for carrying on the taxpayer's trade or business of being an employee, and ordinary and necessary. They include:

1. Business travel, transportation, lodging away from home, meals and entertainment;
2. Safety equipment, small tools, and supplies needed for employment;
3. Uniforms required and not suitable to everyday use;
4. Protective gear such as hard hats, safety shoes and glasses;
5. Dues to professional organizations;
6. Physical exams required by an employer;
7. Professional subscriptions;
8. Job-seeking fees;
9. Home office expenses;
10. Work related educational expenses;
11. Legal fees related to doing or keeping a job; and
12. Continuing education.

Expenses for items like subscriptions, clothing, and professional fees that are personal in nature have never been deductible. It was necessary for those expenses to be related to employment. Now even if related to employment they lose their deductibility.

Tax Preparation Fees

Tax Preparation expenses include professional fees, electronic filing expenses, tax preparation software, and publications. Tax preparation fees were claimed on line 22 of Schedule A.

Miscellaneous Expenses

Other miscellaneous expenses were claimed on line 23 of Schedule A. Included among miscellaneous expenses are those described under IRC Section 212 as they were not excluded from coverage under IRC section 67(b). Section 212 allows individuals to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year: 1) for the production or collection of income; 2) for the management, conservation, or maintenance of property held for the production of income; or 3) in connection with the determination, collection, or refund of any tax." IRS Publication 529 specifically directs the taxpayer to include as Line 23 miscellaneous expenses "any ordinary and necessary expenses to produce or collect reportable income, to manage, conserve, or maintain property held for producing such income, or to determine, contest, pay or claim a refund of any tax."

Speaking in the past tense, in practice this meant that individuals could deduct legal fees that were paid for having their taxes prepared and for advice associated with tax planning. It also meant that individuals could deduct the legal fees related to collecting taxable alimony or for tax advice related to a divorce settlement provided the legal invoice was specific as to how much was related to tax advice. It also meant that they could take a deduction up to two percent of AGI for legal fees incurred in litigation matters that generated income. This was particularly important in contingent fee matters.

The impact of losing these deductions highlights the disparity of tax treatment for business expenses compared with individual and individual employee expenses.

Individual Expenses Compared with Business Expenses

Many of the expenses that could have been deducted by individuals under IRC Section 67 and are no longer deductible on Schedule A, may be deducted by businesses under Section IRC 62(a) and reported on Schedule C to Form 1040. So for example, businesses still have the ability to deduct legal fees and tax preparation fees in their entirety as business expenses while under the new law individuals are no longer entitled to deduct these expenses at all.

In the not-too-distant past there was litigation over whether an expense was related to employment or whether it was related to the taxpayer being in business for himself. This was often an issue for sole proprietors. At stake at the time was whether an expense could be deducted in full (above the line) as a business expense thereby reducing adjusted gross income rather than an expense subject to the two percent of adjusted gross income limit. So there is authority that tells us that a sole proprietor's tax preparation expenses that are business related can be deducted under IRC Section 62 above the line on Schedule C where they were used to determine adjusted gross income. Rev Rul 92-29, 1992-1 CB 20 and IRS Letter Ruling 9234009.

The disparity may compel some to consider shifting status from "employee" to self-employed or independent contractor. IRS has historically scrutinized claims of independent contractor status and penalized employers for mischaracterizing their workers. There are IRS Rulings, Employment Tax Regulations, and case law that assist in determining whether someone should be treated as an employee or as self-employed. A single compelling factor is whether or not the individual has tax withheld from their compensation. But there are other compelling factors that require consideration in the absence of a Form W-2. Because the incentive to be in business rather than to be paid by W-2 is strong, IRS will likely be actively focused on whether an individual is properly classified as an employee or independent contractor with all of the scrutiny it has given this issue in the past.

As the Supreme Court of the United States remarked in 1947 in the case of U.S. v. Silk, 331 U.S. 704 (1947) whether someone is an employee or independent contractor is based upon "the total situation, including the risk undertaken, the control exercised, [and] the opportunity for profit from sound management." The drivers in the Silk case, owned their own trucks, hired their own helpers, paid the expenses of operating their own trucks, were paid on a per-job basis and did not account to anyone for their time. The court concluded in that situation, the drivers were independent contractors.

Since Silk, the IRS, the Department of Labor, and the courts have tried to create guidelines for understanding the differences between employees and independent contractors. Generally, someone is an independent contractor if their employer has the right to control or direct the end result of their work, but not the means and method of accomplishing that result.[2] Therefore if an employer has the right to direct what will be done by its workers and *how* it will be done, there is an employer/employee relationship. Some employees are known as "statutory employees." For those who are not statutory employees, a common law analysis is warranted:

- **Behavioral Control Test.** The more control the company has over how workers perform their work the more likely they are employees. Behavioral control is demonstrated by directing when and where to work; what tools and equipment to use; what assistants may be hired; where to purchase supplies or other services; what work must be performed by the individual rather than delegated; what order or sequence of work to follow; and the level of training provided by the employer to do the job;
- **Financial Control Test.** The more control over the business relationship, the more likely the worker is an employee. Specifically, the courts will look to whether the worker has a personal investment in their tools or their trucks used in the trade, whether they are paid a regular wage, whether they can realize a profit or loss and whether their expenses are reimbursed.
- **Relationship Test.** Other indicators shed light on the type of relationship involved. For example, the existence of a written contract describing the working relationship, the permanency of the relationship and the provision of work benefits.

In addition, if a worker performs services that are integral to the business of the company, it is more likely that the employer will control and direct those activities such that an employer/employee relationship exists. In July 2015, the U.S. Department of Labor, Wage and Hour Division issued a new administrator interpretation of the Fair Labor Standards Act ("FLSA") definition of employee in a measure designed to collaborate with the IRS. The FLSA test focuses on with whether the work performed is integral to the employer's business, whether the worker has an opportunity for profit, whether the worker has any investment risk, whether the work requires special skill and the permanency of the relationship.

Considering the "relationship test" outlined above it is important to comment on the Independent Contractor agreements signed by workers and the impact that agreement might have on determining the employment relationship. While these types of agreements are relevant as to the intent of the employer and employee, they are not determinative. The IRS has stated this principle in the following Letter Ruling:

> A written agreement describing a worker as an independent contractor is viewed as evidence of the parties' intent to create a non-employee relationship. However, a contractual designation, in and of itself, is not sufficient evidence to base a determination of worker status. It is the substance of the relationship, rather than the label, that governs this determination. PLR 199923014.

The United States Tax Court has followed with a number of decisions which reach a similar conclusion holding that such contracts may be "set aside" if they contradict the common law principles defining the relationship. Therefore, while the agreement is evidence of the type of relationship that was intended, the actual circumstances surrounding the relationship will be controlling and may contradict the agreement.

There is an exception (or two) to every rule and this area of the law provides one. If the worker is able to demonstrate that in a segment of a specific industry there is a long standing practice of treating a certain type of workers as independent contractors they mail prevail. Not an easy task.

There is another exception for that class of persons who are identified as "Statutory Employees" under IRC section 3121(d)(3)[3]. Like self-employed individuals, statutory employees can deduct work related expenses above the line and in their entirety on Schedule C. Statutory employees are a limited group and are treated as employees under the Code for the Federal Insurance Contributions Act (FICA, or social security) but not for purposes of IRC sections 62 and 67. Rev. Rul. 90-93, 1990-2 CB 33, IRC Sec(s). 62.

The Lost Deduction for Legal Fees

Legal fees that are incurred by businesses for business purposes reduce AGI and are fully deductible. Legal fees that are incurred for section 212 purposes are deductible subject to the two percent of AGI limit and therefore no longer deductible. So, for example, the loss of the deduction will have a real impact for anyone engaged in litigation with the IRS as the legal fees incurred are no longer deductible. In addition, legal fees that generated income through litigation were deductible subject to the two percent of AGI rule. Now they are no longer deductible.

Before the changes to the tax code, if a taxpayer recovered a court award or settlement, that amount was included in income depending upon the nature of the lawsuit. If the recovery was includable in income then the attorneys' fees associated with that recovery were deductible subject to the two percent of AGI limitation. Conversely, if the award was not included in income then there would be no deduction for attorney's fees. With the elimination of deductions subject to the two percent of AGI limitation, taxpayers who have a litigation recovery that is included in income are not going to get a deduction for that portion of the recovery that represents attorneys' fees. This is particularly significant for contingent fee awards where a percentage of the recovery goes to the attorney who in turn pays tax again on the fee. The result is double taxation of recovery dollars.

The U.S. Supreme Court in Commissioner v. Banks, 543 U.S. 426 (2005) enunciated the general reporting rule on contingency fee arrangements. The client is taxed on the entire amount of a litigation settlement or award, including the portion attributable to the attorney contingent fee. The rationale is the anticipatory assignment of income doctrine, which prevents a taxpayer from diverting income to a third party or creditor without reporting the income. Because the client has ownership over the litigation and the attorney serves as the client's agent, it is consistent to hold the client as taxable owner of the entire proceeds. Under prior law, the taxpayer could then take a deduction for the amount of attorneys' fee paid as a miscellaneous itemized deduction. The net result is that the portion of a recovery attributable to an attorney's contingent fee is taxed twice—first to the litigant and then to the attorney.

Awards for tort-type injuries have been the focus of the courts and the IRS in particular for defining which recoveries are taxable and which are not. IRC Section 104(a)(2) provides an exclusion from income for settlements or awards on account of personal physical injuries or physical sickness but not for emotional distress or punitive damages. Regulations put in place in 2012 removed the prior requirement that a claim be rooted in "tort or tort-type rights" in order to be excluded from income largely because of the statutory necessity of physical injury. At present, the IRC regulations at

Section 1.104-1(c)(2) provide that the "injury need not be defined as a tort under state or common law."

What confounds the courts and practitioners is the inverse principle that physical suffering that is the result of emotional distress does not give rise to the physical-injury income exclusion. The legislative history of Section 104(a) provides some clarification of what symptoms are solely manifestations of emotional distress. These include physical symptoms such as insomnia, headaches or stomach disorders, which are considered primarily emotional manifestations rather than physical harm.

Numerous courts have grappled with this question with often conflicting results. Most recently, the Tax Court held in Maciu Jec, TC Summary Opinion 2017-49 that a former employee of Home Depot couldn't exclude under Code Sec. 104(a)(2) an amount she received from the company to settle a suit alleging discrimination and other actions that she said caused emotional distress. She didn't receive damages for emotional distress attributable to a physical injury or sickness and thus the settlement payment wasn't excludable. For the purpose of tax certainty, attention to settlement documents is critical.

It seems now that the issue of taxability is still a relevant concern but regardless, in neither situation will a taxpayer be able to deduct the attorney's fee that generated the recovery with some exceptions for a long list of civil rights type claims set out in IRC Section 62 (a)(20) and 62 (e). Individuals may deduct these litigation fees "above-the-line" under an alternative statutory right. What is also at issue is whether the case can be made that a recovery is a business expense rather than an employment expense. One individual who sued his employer for breach of employment contract was held to incur legal fees related to employment rather than as a business expense. Alexander v. Internal Revenue Service, 73 F.3d 938 (1st Cir. 1995).

Impact on AMT

For Alternative Minimum Tax ("AMT") purposes the deductions that were subject to the two percent of AGI limit were ignored. Code Sec. 56(b)(1)(A) This made it more likely that a taxpayer would be subject to AMT. It is now likely but not certain that with the absence of these section 67 deductions the taxpayer will have the same amount of tax as before when the AMT triggered additional gain. The increase in AMT exemption limits may create only the illusion of relief for most taxpayers who are losing their itemized deductions. Code Sec. 55(d)(4)(A) as amended by TCJA Section 12003(a).

Some suggest that one solution is to have an employer reduce the salaried income of an employee and then reimburse an employee for expenses under an Accountable Plan under which the payments by the employer are not deductible and the payments "received" by the employee are not income. Another more problematic solution is to redefine the status of an employee as an independent contractor. Employees stand to lose in other ways by this reclassification from the loss of benefits like health insurance, pension funds and fringe benefits.

II. TRANSPORTATION EXPENSES

The TCJA changes the way business-related expenses are accounted for by employees, employers and self-employed owners of businesses. The biggest change is for employees who can no longer deduct unreimbursed expenses related to their employment under the new Code section 67(g) (2017 Tax Cuts and Jobs Act Section 11045(a)). As set forth earlier, section (g) provides that "[n]otwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026."

That deduction allowed employees to itemize and deduct those expenses on a tax return to the extent that "the aggregate of such deductions exceeds 2 percent of adjusted gross income." One of the larger expenses in this category has been the cost of transportation and parking. An employee that paid for these types of expenses had the option to take a miscellaneous deduction if they were reasonable and job related. That opportunity is "suspended" for now until at least January 1, 2026.

Employers have the option of reimbursing an employee for the cost of parking and commuting expenses. An employer's reimbursement might have no tax effect for either the employer and employee or could result in income to the employee with a corresponding tax deduction for the employer. The result variable depends upon the business structure of the employer, the status of employment for the worker, or the presence of a formal written plan of reimbursement. Going forward, the tax implications depend upon who pays for the benefit and whether reimbursement to an employee is provided pursuant to a written Accountable Plan under IRC Section 62 or Fringe Benefit Plan under IRC Section 132(a) or whether it meets the definition of a "Qualified Transportation Fringe" under IRC section 132(f) of the new Act.

Accountable Plan under IRC Section 62

Under an Accountable Plan, an employee does not realize income for the benefit provided and the employer does not take a deduction for the expense. There is a symmetry. No deduction and no income. An Accountable Plan provides a benefit that is an "above the line" deduction for an employee under IRC Section 62(a)(2)(A) reducing adjusted gross income without being subject to the limitation on miscellaneous itemized deductions (which has been eliminated by this new Act.)

An Accountable Plan must have business-connection and substantiation requirements and must compel the employee to return any amounts received in excess of benefits within a reasonable amount of time. IRS Reg. Section 1.62-2 provides additional detail for what will qualify as an Accountable Plan. The Regulations make it clear that all amounts must be related to the performance of service of the employee and must be of such a type that they would have been allowed as a deduction under IRC section 161 through 196. The plan can allow for a cash advance, specific allowances for items such as meals, mileage or incidental expenses, or reimbursement for substantiated expenses.

Any Plan that fails any one of the Accountable Plan requirements is a Non-Accountable Plan.[4] In that event the employee must include the reimbursement in gross income and deduct the expenses reimbursed as miscellaneous itemized deductions subject to the two percent limitation. These reimbursements are reported on the Form W-2 of an employee for which the employer must subtract withholding and employment taxes.[5] Given that it is no longer possible to take a miscellaneous itemized deduction the employee will recognize income and receive no deduction. The employer will be entitled to a deduction for employee expenses paid under a non-accountable plan.

Working Condition Fringe Generally under IRC Section 132(a)(3)

Section 132(a)(3) provides that an employee's gross income does not include any amount that is a working condition fringe benefit. A working condition fringe "means any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167."[6] In other words, a working condition fringe is a benefit provided to the extent that: 1) the employee could have deducted the expense himself; and 2) the expense would have been a deductible trade or business expense under section 162; and 3) the employee's deduction from personally paying for that expense would have been incurred in connection with the employee's trade or business of being an employee of the employer.

The expense may be deducted by the employer if it can be established that it is either intended as additional reasonable compensation for services of an employee [7] (in which case it is included in the income of the employee) or if not then it can be shown that it is an ordinary and necessary business expense under IRC Section 162 (and not included in the income of the employee).

Qualified Transportation Fringe up to $260/month under 132(f)

Under the new Act and starting in 2018 transportation related fringe benefits are given new treatment. An employer can no longer take a deduction for the expense of providing an employee with a Qualified Transportation Fringe Benefit as defined in Section 132(f) (See new IRC Section 274(a)(4)) or for commuting expenses (new IRC Section 274(l)). While not deductible by the employer, the benefit will also not be included in the income of the employee—for the most part. A qualified transportation fringe under 132(f) is:

1) transportation in a commuter highway vehicle for travel between the employee's residence and place of business;

2) transit passes;

3) qualified parking on or near the employer's business or at a location from which the employee commutes to work. "Parking" is considered provided by the employer if the employer: 1) pays for the parking directly; 2) pays by reimbursing the employee; or 3) provides parking on its own premises that it owns or leases.

4) qualified bicycle commute expense reimbursement.

The income exclusion for a Qualified Transportation Fringe Benefit described above is limited to a maximum monthly amount. Amounts paid by the employer that exceed that amount are included in the employee's income. In 2018 that amount is $260 a month. It is unclear whether the excess is ever deductible by the employer. While the excess Qualified Transportation Fringe Benefit won't be deductible because the new Act made that change it might be possible for an employer to deduct the expense as an ordinary and necessary business expense or as additional employee compensation.

While some commuting expenses are delineated above as a Qualified Transportation Fringe under Section 274(a) there is a new IRC Section 274(l) which also prohibits an employer's deduction for transportation and commuting benefits—except as necessary for the safety of the employee. Section 274(l) provides:

(1) In general.

No deduction shall be allowed under this chapter for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee.

(2) Exception.

In the case of any qualified bicycle commuting reimbursement (as described in section 132(f)(5)(F)), this subsection shall not apply for any amounts paid or incurred after December 31, 2017, and before January 1, 2026.

It is unclear why this ban on a commuting deduction is a stand-alone provision as it seems to supplement the revised 274(a) which seems to already cover commuting costs. On closer observation, the stand alone provision of 274(l) is more comprehensive ("any transportation" rather than simply "commuter highway vehicle") and creates an exception for transportation safety. So while the employer's deduction for a broad swath of commuting expenses is prohibited the question arises whether any employer reimbursement of these expenses is income to the employee. If IRC Section 274(l) relating to the commuting expense deduction is read as also modifying Section 132(f) then these commuting reimbursements are counted in the limit on all Qualified Transportation Fringe Benefits found in 132(f)(2) which as mentioned previously is only $260 a month for 2018. The employee will realize income to the extent the value of the benefit exceeds that amount.

If 274(l) does not modify Section 132(f)—and there is no reference back to Section 132 in the language of the new code section—then the employee might realize income on the entire amount of the commuting reimbursement unless this benefit falls into another category such as working fringe benefit under IRC Section 132(a)(3). What might put the brakes on this outcome is Section 132(f)(7). Employee income is only excluded to the extent it is a Qualified Transportation Fringe benefit or working fringe benefit. Section 132(f)(7) makes it clear that the term "working condition fringe" does not include "qualified transportation fringe" making it impossible to re-characterize the expense as a working condition fringe.

It may also be worth speculating whether an employer's direct payment of an employee's commuting expense i.e. their UBER/LYFT bill is income to the employee under an alternate theory of third party payment of liability. "The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." Old Colony Trust Co. v. Commissioner, 49 S. Ct. 499 (1929).

Regardless of the impact on the employee, it does seem clear that in no event can the employer claim a deduction for the commuting benefit provided with that one exception being the safety of the employee. The question is whether an employer can find relief by trying to re-characterize a commuting benefit as compensation to an employee or as an ordinary and necessary business expense of the employer under IRC Section 162.

Analysis

With the loss of the deduction for miscellaneous itemized expenses that exceed two percent of adjusted gross income, employees will seek to retain the benefits formerly provided by employers without having those reimbursements included in income. One solution is the adoption of an Accountable Plan by an employer although the employer receives no deduction for providing those benefits. A second solution is for an employer to provide the minimal benefit of a Qualified Transportation Fringe Benefit which in 2018 is merely $260 a month after which the value of the benefit is included in the employee's income. The amount that is excluded from income under an Accountable Plan is without limit, unlike the Qualified Transportation Fringe Benefit. There is also no maximum monthly amount for a working condition fringe benefit.

For employers there will be an incentive to deduct employee related expenses as either paid compensation or as an ordinary and necessary business expense under section 162. This means that the value of those benefits will be included in the income of the employee. This scenario unfolds under a Non-Accountable Plan or where the Qualified Transportation Fringe Benefit exceeds the minimal monthly amount. Fringe benefits other than commuting benefits under 274(l) can only be deducted if they are ordinary and necessary business expenses or characterized as compensation to an employee.

In comparison, independent contractors and owners or partners can fully deduct these expenses—including transportation related expenses—because they are considered "trade or business expenses" which are not subject to the two percent floor but rather reduce adjusted gross income. The disparity in tax treatment for individuals and companies or the self-employed is once again manifest by the suspension of employee expense deductions by the Tax Cuts and Jobs Act.

III. THE END OF ALIMONY

Presently, or at least until January 1, 2019, alimony can be taken as an income tax deduction by the payor of alimony under IRC Section 215(a) and should be reported as income by the recipient under IRC Section 61(a)(8). In order to be deductible, payments have to be made in cash and as a result of a divorce or by a separation agreement. The parties have to live separate and apart and the obligation has to terminate after the death of the recipient. The terms of payment cannot provide for any substituted transfers in the event of non-payment.

Section 11051 of the Tax Cuts and Jobs Act of 2017 upends this long standing tax approach by removing the alimony tax deduction and at the same time no longer requiring alimony to be reported as income when received.[8] Nothing happens in a vacuum and the result of this simple declaration has ripple effects for a large body of tax law in place. Examples follow.

Rush To Sign by December 31, 2018

The change in the law will not impact anyone with an agreement in place by December 31, 2018. This will undoubtedly have a profound impact upon negotiations with a rush to complete final agreements by year end 2018. In addition, the IRS will be faced with the mighty task of determining which tax returns should be reporting alimony under the old scheme—income to recipient and deduction for payor—or, under the new scheme, no income reporting and no deduction. Under the new law the payment will be a non-event from a tax point of view so that only those agreements under the old law will be showing up on tax returns. But only a tax audit will elicit proof that a taxpayer is entitled to a claimed deduction with the taxpayer providing evidence of a qualified pre-2019 agreement. Perhaps new revised tax reporting on Form 1040 (the standard individual tax return) will compel attachment of such agreements for every return claiming the deduction. Could this be problematic for payment recipients? Possibly at least because the taxation symmetry requires them to report alimony as income and at least on Form 1040 to date the payor of alimony is required to supply the tax identification number of his or her spouse who receives income.

Is It Alimony or Property Division? Alimony Recapture No Longer Recalculated

The IRS devised a set of rules to prevent front-loading of payments and calling them alimony when in reality they are non-deductible property transfers. The recapture laws found at IRC Section 71(f) would result in the reversal of an alimony deduction. Because there is no longer an alimony deduction, there is no longer an incentive to disguise property division as alimony. It would seem then that the entire set of alimony recapture laws are no longer operative for agreements entered into after December 31, 2018. The way the recapture law worked was through a computation that was done post-facto. The amount of the recapture which was realized in the third year after alimony had begun was calculated by taking the excess of alimony payments in the second year over the sum of payments in the third year plus $15,000, PLUS the excess of the payments in the first year over the sum of the average payments in the second year and third year plus $15,000. A complicated calculation that will not be necessary going forward and for some a welcome relief.

Will We Even Need an Agreement Going Forward?

In order for alimony to be deductible, the payments (in addition to other things) had to be made pursuant to a written divorce or separation agreement or court order. IRC Section 71(b)(2) There are many cases dealing with the question of whether something is or is not a written separation agreement. One such case Mudrich, TC Memo 2017-101 held that a husband's promise to split his bonus with his ex-wife was not made pursuant to a satisfactory agreement and therefore denied him the alimony deduction. The agreement called for the separation of an item of property but never mentioned that the payment was for spousal support.

There have been other opportunities for drafting mishaps. The Code also requires payments to cease upon the death of payor in order to be considered alimony. There is disagreement between the IRS and the Tax Court regarding whether the amount of alimony must be a definite amount (the IRS view) or an ascertainable amount (the Tax Court view).

It seems that all of these issues requiring careful drafting are going to be a thing of the past.

Phantom Alimony—Gone!

Payments to others on behalf of the recipient spouse may be alimony if required under a property settlement agreement. The result of this scenario is that the beneficiary of these payments had taxable income but no cash with which to pay the tax. How does it work? For example, payments that the payor spouse makes directly for rent, mortgage, tax or maintenance on a home owned by the payee spouse will qualify as deductible alimony. (The same does not hold true if the home is in the name of the payor spouse regardless of what is stated to in a property settlement agreement.) Half of what is paid for these home related expenses on a jointly owned home in which the payee spouse continues to reside may be deducted as alimony. In addition, life insurance premiums that a payor spouse was obligated to pay by reason of a property settlement agreement directly to a life insurance company were alimony so long as the policy was owned by the payee spouse. Now, none of these payments are income and none are deductible by the paying spouse. Phantom income is gone.

Tax Implications Are Still A Factor For Determining Alimony Under Local Law

Our Pennsylvania Statute, 23 Pa. C.S.A. Section 3701, states that the "Federal, State and local tax ramifications of the alimony award" are a factor when determining whether alimony is necessary, the amount of alimony and the duration. The current automated calculations reach an amount of alimony generally based upon relative incomes and expenses. The comment to Pennsylvania Rule Section 1910.16-4 tells us that "the tax consequences of an order for a spouse alone or an unallocated order for the benefit of a spouse and child have already been built into the formula." The question is whether these programs correct for the tax implications of alimony and whether going forward, the loss of the alimony deduction changes that calculation. Very simply, the loss of the deduction increases the amount paid as well as the amount received. Some adjustment seems warranted.

Currently, spouses are at liberty to alter the tax consequences of alimony by agreement so that the payor no longer receives the deduction and the recipient no longer includes payments in income. An overall savings may be the motivation.

> Illustration: Husband pays $20,000 a year for support. Husband is in the 28 percent tax bracket, and Wife is in the 15 percent tax bracket. If the payments are alimony then Husband saves $5,600 in taxes. Wife includes the entire amount as alimony and pays a tax of $3,000. The savings of $2,600 represented by the difference in tax reporting can be incorporated into the final divorce agreement.

These adjustments will no longer be available however the cost of support/alimony to the payor will vary from person to person depending on their own individual tax status. Will this be considered as part of the settlement process or the alimony calculation? We don't know.

Allocation Headaches Over?

When support for children is required in addition to alimony or spousal support, it has been the best practice to clearly identify each payment since child support, unlike alimony, is neither deductible by the payor or included in the income of the recipient. In those cases where it was unclear how much of a payment was deductible alimony and how much was non-deductible child support litigation often ensued. When IRS was involved, the Service would conduct a facts and circumstances analysis to apportion a single payment between deductible and nondeductible support. For example, the Service might consider whether there was an agreement to reduce payments upon the occurrence of certain events like a child's graduation from High School. The reduction would imply an amount designated as nondeductible child support.

If the taxpayer owed a combination of child support and alimony and during the year paid less than obligated, then the payments were first allocated to child support regardless of whether the parties agree otherwise. [9] By way of illustration:

> Husband is obligated to pay to Wife $20,000 for alimony and $12,000 for child support and pays only $8,000 for the year, then the entire amount is treated as non-deductible child support and none of the payments are allocated to alimony.

None of this tax planning is required now that alimony is no longer deductible or income. There is no tax difference between the payment of child support or alimony. At least that will be the law for agreements entered into starting in 2019.

Personal Exemptions Eliminated

Under the law as we knew it before 2017 tax reform, taxpayers adjusted their gross income by taking personal exemptions for themselves, their spouse and dependents. For 2018 that exemption was going to be $4,150 for each person subject to a phase out based upon income. Under the new law, for tax years 2018 through 2025, the personal exemption is zero.[10]

The personal exemption was a subject for negotiation in divorce settlements. [11] A husband and wife could not both claim an income tax exemption for the same child. Presently, in the absence of agreement, the exemption belongs to the custodial parent defined by the Code as "the parent having custody for a greater portion of the calendar year."[12] IRC Section 152(e)(4)(A) (If days are equal, the exemption belongs to the parent with the highest adjusted gross income.)

A custodial parent can release the dependency exemption to the non-custodial parent in a written declaration that is 1) signed by the custodial parent; 2) must state the years to which it applies; 3) must name the non-custodial parent who is the recipient of the exemption; and 4) must be unconditional. In order to claim the exemption, the noncustodial parent must file with his or her tax return this written declaration on IRS Form 8332 or a similar statement containing all of the same information. A court order is insufficient if it does not have the signature of the custodial parent attached. The Tax Court has held that the Form must actually be attached to the return and cannot be submitted at a later date. The release of the dependency exemption can be revoked under a similar process using Form 8332.

A **"qualifying child"** dependent as defined under Section 201 of the Working Families Tax Relief Act of 2004 (1) must be the taxpayer's child (including adopted or foster child), stepchild, sibling, or stepsibling or a descendent of such a relative; (2) has the same principal place of abode as the taxpayer for more than one-half of that tax year; (3) must be under age 19 at the close of the calendar year, under age 24 if a full-time student, or of any age if permanently and totally disabled; (4) hasn't provided over one-half of his own support for the calendar year in which the taxpayer's tax year begins; and (5) hasn't filed a joint return (other than for a refund claim) with the individual's spouse for the tax year beginning in the calendar year in which the taxpayer's tax year begins. For purposes of the Child Tax Credit a qualifying child is under age 17.

Will it Matter Who Has the Dependency Exemption in the Future?

While the dependent status of a child is not significant for purposes of claiming the personal exemption on a tax return, there are other tax reasons for claiming a child as a dependent. First, while the personal exemption is temporarily zero, it may someday—after 2025—return. Further, there is still a $500 deduction for dependents over 17 or older.[13] And importantly, only the parent with the dependency exemption may claim the child tax credit now $2,000 under the new law.

Even when there is a release and transfer of the dependency exemption *both* parents may claim the child as a dependent for purposes of excluding medical reimbursements, excluding employer-provided accident or health plan coverage, deducting medical expenses, the exclusion of health savings account distributions for qualified medical expenses and the exclusion of Archer medical savings account distributions to pay qualified medical expenses—to the extent these deductions and credits survive the 2017 reform act. So for example, in 2017 and 2018 medical expenses can still be itemized but only to the extent they exceed a floor equal to 7.5 percent of adjusted gross income. Most other deductions are "suspended" by the new law. Starting in 2019, medical expenses will be subject to the 10 percent floor for both regular tax and AMT purposes.

So, a custodial parent, even without the dependency exemption, can still claim the child and dependent care credit, the exclusion for dependent care benefits, the health coverage tax credit, the earned income tax credit and head of household status. Only the parent with the dependency exemption can claim the child tax credit. For this alone it matters which parent has the dependency exemption.

Notes

1 IRC Section 67(b) Miscellaneous itemized deductions. For purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than—
   (1) the deduction under section 163 (relating to interest);
   (2) the deduction under section 164 (relating to taxes);
   (3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d);
   (4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose);
   (5) the deduction under section 213 (relating to medical, dental, etc., expenses);
   (6) any deduction allowable for impairment-related work expenses;
   (7) the deduction under section 691(c) relating to deduction for estate tax in case of income in respect of the decedent);
   (8) any deduction allowable in connection with personal property used in a short sale;
   (9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right);
   (10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered);
   (11) the deduction under section 171 (relating to deduction for amortizable bond premium); and
   (12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

2 Employment Tax Regulation Section 31.3401(c)-1. Employee. (b) Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.

3 Section 3121(d)(3)

any individual (other than an individual who is an employee under paragraph (1) or (2)) who performs services for remuneration for any person—

(A) as an agent-driver or commission-driver engaged in distributing meat products, vegetable products, fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services, for his principal;

(B) as a full-time life insurance salesman;

(C) as a home worker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by such person which are required to be returned to such person or a person designated by him; or

(D) as a traveling or city salesman, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his principal (except for side-line sales activities on behalf of some other person) of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations;

if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term "employee" under the provisions of this paragraph if such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed;

4 IRC Section 62(a)(2)(A)

5 See Treas. Regs Sections 1.162-2, 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2) and 31.3401(a)-4(b)(2)

6 IRC Section 132(d)

7 IRC Section 274(e)(2)

8 IRC Section 61(a)(8); IRC Section 71; IRC Section 62(a)(10)

9 IRC Section 71 (c)(3); Haubrich, TC Memo 2008-299

10 IRC Section 151(d), as modified by Act Sec. 11041(a)

11 152(e) Special rule for divorced parents, etc. (1) In general. Notwithstanding subsection (c)(1)(B), (c)(4), or (d)(1)(C), if – (A) a child receives over one-half of the child's support during the calendar year from the child's parents – (i) who are divorced or legally separated under a decree of divorce or separate maintenance, (ii) who are separated under a written separation agreement, or (iii) who live apart at all times during the last 6 months of the calendar year, and – (B) such child is in the custody of 1 or both of the child's parents for more than one-half of the calendar year, such child shall be treated as being the qualifying child or qualifying relative of the noncustodial parent for a calendar year if the requirements described in paragraph (2) or (3) are met.

(2) *Exception where custodial parent releases claim to exemption for the year.* For purposes of paragraph (a), the requirements described in this paragraph are met with respect to any calendar year if—(A) the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year, and (B) the noncustodial parent attaches such written declaration to the noncustodial parent's return for the taxable year beginning during such calendar year.

12 IRC Section 152(e)(4)(A)

13 See Section 11022 modifying IRC 24(h)(4)(A) & (h)4)(C)