

**TAX LAW CHANGES:
CHILDREN, EDUCATION AND NEW TIPS**

Presented by

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TAX CONSEQUENCES OF DIVORCE

I. DEFINITIONS

- A. Alternative Minimum Tax: tax designed to ensure that all taxpayers pay at least a minimum amount of taxes.
- B. Unallocated v. Allocated Support
 - 1. Requirements to be considered Maintenance:
 - a. paid in cash
 - b. provided for under a divorce or separation agreement
 - c. must terminate upon death of the payee
 - d. If payments are contingent upon conditions set forth in the divorce agreement relating to the child, the payments are deemed "fixed" and are child support which will destroy unallocated treatment.
- C. Dependency Exemptions: deduction from adjusted gross income for taxpayer's dependent children for whom the taxpayer provides more than one half of the dependent's support; dependent must be under 19 years old or be a full time student.
- D. Child Care Credit: non-refundable personal credit for taxpayers with dependent children under 17 years of age.
- E. Retirement Accounts:
 - 1. IRAs in general (§408): IRAs enjoy freedom from taxation of earnings until distributions are made and some deductibility of annual contributions.
 - 2. Roth IRA: Yearly contribution limited to \$2,000; taxable upon contribution; not taxable upon distribution.
- F. Sale or Exchange of Marital Residence: exclusion of up to \$250,000 (\$500,000 for married filing jointly) of gain recognized on sale or exchange of a principal residence.

II. ANALYSIS AND DISCOVERY

- A. Income
 - 1. Gross Salary
 - 2. Support Paid or Received
 - a. child support (§71(c)(2)(A):
 - (1) If unallocated maintenance payments drop within 6 months (before or after) of the child attaining the age of majority,

that portion of the payment will be deemed child support from year one.

- (2) If there are two drops in unallocated maintenance payments, and any two drops are within one year (before and after) of two kids turning the same age between 18 and 24, that portion of the payment will be deemed child support from year one.
- (3) If payments end after the sixth post separation year, this rebuts the presumption that payments are child support.

- b. alimony: taxable to payee; deductible to payor
- c. non-taxable maintenance
- d. previous marriage support obligations

B. Number of Children

1. Exemptions for Dependent Children: Who is taking the exemptions? The custodial parent takes the children as exemptions unless otherwise specified regardless of the parent paying support.
2. Child Care Expenses: Schedule A Deduction
3. Child Care Credit: For taxable years beginning in 1998, taxpayers will be eligible for a \$400 credit for each qualifying child.
 - a. Qualifying Child:
 1. Age Requirement: The child must be under age 17 at the close of the calendar year in which the taxpayer's taxable year begins.
 2. Dependency Requirement: The child must be an individual for whom the taxpayer can claim a dependency exemption.
 3. Relationship to Taxpayer: The child must be the taxpayer's son or daughter (or descendant of either), step-child, or eligible foster child.
 4. Citizenship: The child must be a citizen, national or resident, of the United States
 - b. Phase-Outs:
 1. Rate: The phase-out rate is \$50 for each \$1,000 of modified AGI in excess of the threshold.
 2. Threshold:
 - a. Joint Returns: \$110,000
 - b. Single or Head of Household Returns: \$75,000

- c. Married filing Separately: \$55,000
 - d. Adjusted Gross Income for purposes of the threshold determination is gross income, increase by any amount excluded from gross income under §911, §931, or §933 of the I.R.C.
 - e. Total credit is reduced by \$50 for each \$1,000 of AGI over the Threshold.
3. Three or More Children: There is a separate formula for taxpayers with one or two qualifying children and another formula for taxpayers with three or more qualifying children.
- a. Additional credits to families with three or more children.
 - b. Problems:
 - (1) Lower income families who get Earned Income Credit may not have enough taxable income to use the Child Credit.
 - (2) Families with several children could become subject to Alternative Minimum Tax and not allowed Child Credit.
4. Impact on Child Support Payment Calculations:
- a. a tax credit of \$400 per child adds that amount to "guideline" calculations of child support.
 - b. Unallocated support arrangement:

C. Other Income

- 1. Securities
- 2. Dividends
- 3. Capital Gains

D. IRAs

- 1. Roth IRA:
 - a. The 1997 Taxpayer Relief Act requires that if you convert from a traditional IRA to a Roth IRA in 1998, the amount converted is includible in income ratably over a four year period. You may elect to recognize all the income in the year of conversion. I.R.C. § 401A.

- b. The new rules provide that you may convert back to a traditional IRA from a Roth IRA. I.R.C. §408.
 - c. Make sure to ask your client if they contribute to a Roth IRA because it will not show up on the tax return.
 - 2. IRA Modifications: The 1998 Act makes it clear that the phased out dollar limitation for deductible IRA contributions applies whether a married individual or the individual spouse is an active participant in an employer-sponsored retirement plan. I.R.C. § 219(g)(1).
- E. Income which Impacts Cash Available for Child Support but not Federal Taxes
 - 1. Depreciation Expenses
 - 2. Roth IRA Conversions
 - 3. Subchapter S Income
- F. Alternative Minimum Tax: Taxpayers are generally subject to an alternative minimum tax if it is higher than the tax computed according to the general rules.
 - 1. Alternative Minimum Tax is a fixed percentage of alternative minimum tax income.
 - 2. Alternative minimum tax income is computed by determining a taxpayer's taxable income increased by the amount of items of tax preference (ex. child care credit).
- G. Education Credits
 - 1. Interest on Education Loans:
 - a. Provision of the Act permits taxpayers to deduct interest paid on qualified higher education loans taken for themselves, their spouses, or dependents when the debt is incurred.
 - b. Applies to the interest paid during the first 60 days in which interest payments are required on the loan and is effective for payments of interest due after 1997.
 - c. The interest deduction is available whether or not the taxpayer itemizes deductions. Allowable maximum deductions per years were established by the Act.
 - d. The interest deduction is phased out as income rises.
 - 2. Hope Scholarship Credit: Commencing in 1998, this credit will be available against federal income taxes for qualified tuition (not room, board or books) for a student's first two years of post-secondary education at an eligible institution.
 - a. Subject to phase-out, the credit is equal to 100% of the first \$1,000 of qualified expenses during the year plus 50% of the next \$1,000.

- b. The expenses must be incurred on behalf of the taxpayer, his or her spouse, or a dependent.
 - c. Maximum credit of \$1,500 is allowed per student.
3. **Lifetime Learning Credit:**
- a. Available for qualified tuition (not room, board or books) an eligible educational institution for post-secondary education expenses.
 - b. Credit includes expenses for courses to acquire or improve job skills.
 - c. Prior to 2003, the credit applies to expenses up to \$5,000. After 2003, the credit is equal to 20% of expenses up to \$10,000.
 - d. The credit can be used for expenses paid after June 30, 1998 for academic periods commencing after that date.
 - e. Available to the taxpayer, spouse and dependents.
 - f. Maximum credit is the same per taxpayer regardless of the number of students in the family.
4. The Act exempts qualified higher education expenses of the taxpayer from the 10% early withdrawal tax of §72(t) distributions from an IRA.

H. Sale or Exchange of a Principal Residence:

- 1. **Old Law:** Rollover gain on the sale or exchange of a principal residence and a one time \$125,000 exclusion for the sale of a principal residence by taxpayers age 55 or over.
- 2. **New Law:** Exclusion of up to \$250,000 (\$500,000 for married taxpayers filing jointly) of a gain realized on the sale or exchange of a principal residence.
- 3. **Eligibility:**
 - a. Ownership and Occupation as a principal residence for at least two years in the five year period before the date of the sale or exchange; use need not be continuous and uninterrupted but cumulative.
 - b. If the taxpayer does not meet these requirements due to a change of place of employment, health or unforeseen circumstance, the taxpayer may exclude the fraction of the \$250,000 (\$500,000 if married filing a joint return) equal to the fraction of two years that the requirements are met.
- 4. If joint filers are not sharing the principal residence, each spouse may exclude up to \$250,000 of gain from the sale or exchange of their principal residence provided that each spouse would be permitted to exclude up to \$250,000 of gain if they filed separate returns.

5. If a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the newly married taxpayer is allowed a maximum exclusion of \$250,000.
6. Once both spouses satisfy the eligibility rule and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude \$500,000 of gain on their joint return.
7. Problems: The \$500,000 exclusion is only available where the parties file a joint return in the year of sale. They cannot file a joint return if they have been divorced prior to the sale of the home. This may have little impact since each still qualifies for \$250,000 of the exclusion upon separate returns following sale of the residence assuming a co-tenancy exists between the parties.
8. Asset: Freedom from payment of a future tax will make this property even more valuable as an item of concession in negotiations, leaving less incentive for the non-residential spouse to retain financial or ownership interest in the former marital home.
9. Tacking: The new legislation permits a "tacking" of one spouse's continued use of the home to the other spouse's such that the non-residential spouse may still qualify for the deduction when the home is sold in the future.

III. GETTING IT INTO EVIDENCE

A. Computer Generated Business Records as the Sole Source of Information:

1. May be admissible under Supreme Court Rule 236 with proper foundation
2. Foundation includes:
 - a. that the electronic equipment is recognized as standard equipment;
 - b. that the entries were made in the regular course of business at or reasonably near the time of the happening of the event recorded; and
 - c. that the sources of information and method and time of preparation indicate trustworthiness.

B. Computer Generated Summaries or Analyses made from actual documents or from computer generated business records:

1. Lawyer should analyze the nature of the source documents being summarized and combine the foundation for this information with a foundation for the reliability of the computer equipment
2. Programs: FinPlan and Back Calc