

Client Bulletin

Smart tax, business and planning ideas from your Trusted Business AdvisorSM

May 2018

The new tax law will change divorce tactics



When couples divorce, financial negotiations often involve alimony. The tax rules regarding alimony were dramatically changed by the Tax Cuts and Jobs Act (TCJA) of 2017, but existing agreements have been grandfathered. In addition, the old rules remain in effect for divorce and separation agreements executed during 2018. Next year, the rules will change, and the roles will be reversed.

Under divorce or separation agreements executed in 2018, and for many years in the past, alimony payments have been tax deductible. Moreover, these deductions reduce adjusted gross income, so they may have benefits elsewhere on a tax return. While the spouse or former spouse paying the alimony gets a tax deduction, the recipient reports alimony as taxable income.

Shifting into reverse

Beginning with agreements executed in 2019, there will be no tax deduction for alimony. As

an offset, alimony recipients won't include the payments in income.

Example 1: Joe and Kim Alexander get divorced in 2018. Joe expects to be in a 35% tax bracket in the future, whereas Kim anticipates being in a 22% bracket. Suppose that the proposed agreement has Joe paying \$3,500 a month (\$42,000 a year) in alimony.

Joe will save \$14,700 in tax (35% times \$42,000), but Kim will owe \$9,240 (22% times \$42,000). Net, the couple will save over \$5,000 per year in taxes. This type of calculation will affect the negotiations, as it has in the past. Assuming the relevant rules are followed, it may make sense to tip the agreement toward Joe paying alimony to Kim, perhaps in return for other considerations.

Example 2: Assume that the Alexanders' neighbors, Len and Marie Baker, have identical finances. They divorce in 2019. If Len pays \$42,000 a year in alimony, he will get no deduction and won't get the \$14,700 in annual tax savings that Joe did in example 1. Marie, on the other hand, will pocket \$42,000, tax-free, without the \$9,240 tax bill faced by Kim in example 1.

Moving things along

Just as people shouldn't "let the tax tail wag the investment dog," so taxes shouldn't dominate divorce or separation proceedings. However, it's also true that taxes shouldn't be

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Global expansion

The broadest global expansion in seven years occurred during 2017, with economic growth in 120 countries that accounted for three-fourths of world economic output.

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Trusted advice

Defining alimony

Payments to a spouse or former spouse must meet several requirements to be treated as alimony for tax purposes. The following are some key tests:

- The payments are made under a divorce or separation agreement.
- There is no liability to continue the payments after the recipient's death.
- The payments aren't treated as child support or a property settlement.
- The payments are made in cash (including checks or money orders).

ignored. If you are in such a situation, our office can help explain to both parties the possible savings available from executing an agreement during 2018, rather than in a future year.

The new rules will be in effect beginning in 2019. With no alimony deduction and a tax exemption for alimony income, it may be desirable to consider after-tax, rather than pre-tax, income when making decisions. Speaking very generally, there may be less cash for the couple to use after-tax.

Keep in mind that, as of 2019, not all states will have alimony tax laws that conform to the new federal rule. Your state may still offer tax deductions for alimony payments and impose income tax on alimony received. That's all the more reason to look at after-tax results when calculating a divorce or separation agreement.

Getting personal

The impact of the new TCJA on spousal negotiations may go beyond the taxation of alimony. Among other provisions to consider, the TCJA abolishes personal exemptions. As a tradeoff, the standard deduction was almost doubled (see *CPA Client Bulletin*, April 2018).

In some past instances, divorcing spouses would agree that the high bracket party would claim the children's personal exemptions, which effectively were tax deductions, in return for some other consideration. Now those exemptions don't exist, so they shouldn't be part of divorce negotiations. If you previously entered into an agreement that included the treatment of children's personal exemptions, you may want to consult with counsel to see about possible revisions.

Stretching for yield...carefully

Typically, bond funds with low yields have relatively low risk (see the *CPA Client Bulletin*, March 2018). That doesn't mean that these funds are riskless, though. With interest rates expected to rise this year, all types of bond values could drop, leading to an overall pullback in the prices of bond fund shares.

One way to respond to this unwelcome outlook is to diversify your fixed income holdings.

Example: Jane Miller has a target asset allocation of 60% in stocks and 40% in bonds. Working with her financial adviser, Jane puts half of that fixed income allocation (20% of her entire portfolio) into bond funds that mainly hold short-term issues from government entities and financially sound corporations. Such funds are likely to have low yields, but they

probably will hold most or all of their value in the coming months and years.

These lower risk funds may be considered core fixed income investments.

Beyond the norm

Assume that Jane can tolerate some volatility in her portfolio. If so, she might put the other half of her fixed income allocation into these types of bond funds:

- **High-yield funds.** These funds typically invest in corporate bonds that are unrated or low rated by specialized agencies, perhaps because the issuers are not in excellent financial condition. Fund holdings may be known as *junk bonds*. Yields are relatively high, but bond prices might drop in times of economic weakness, which can raise

doubts about the companies' ability to meet interest and redemption promises. This danger, known as *credit risk*, may be reduced if the fund holds many issues because most of a professionally chosen portfolio is likely to avoid defaults.

- **Emerging markets bond funds.** Holdings include bonds from governments and companies based

Did you know?

Among Baby Boomers (age 52 and older), 46% considered delaying retirement beyond the original target date in 2017. In 2015, the percentage was 47%. By comparison, 41% of Millennials (age 18–35) considered such a delayed retirement in 2017, up from 30% in 2015.

Source: T. Rowe Price

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in areas considered to be developing economically. For example, such places could range from Brazil to Russia to South Africa. Currency movements may affect returns positively or negatively, but there might be little influence from U.S. interest rate moves.

- **Bank loan funds.** As the name indicates, such funds purchase loans made by banks. The borrowers are usually companies; frequently, the loans are used to finance acquisitions. Questions about the borrowers' ability to repay the debt make these funds vulnerable to recessions and low growth periods. On the other hand, bank loan funds generally invest in variable rate debt, so borrowers' payment obligations (and the dividends to investors) can go up when interest rates rise.
- **Preferred stock funds.** Whereas familiar stock funds own *common* stock of issuers, these funds buy *preferred* shares. The name indicates that investors will be paid before common stock holders, in case the issuer can't meet all its obligations. Preferred stock payouts come before dividends on common shares. In practice, preferred shares tend to pay fixed bond-like yields,

and trading prices may have low volatility. Preferred stock funds can be considered more like bond funds than stock funds.

- **Municipal high yield funds.** These funds hold tax-exempt municipal bonds from issuers that do not have a sterling credit rating. In essence, these funds are the tax-exempt cousin of the high-yield funds mentioned previously in this article, which pay taxable interest.

As is the case with all municipal bonds and muni bond funds, they should be held in taxable accounts to use their exemption. The other types of funds covered here may be favored for tax-deferred accounts such as IRAs, for which the high dividend payments can compound without a current tax haircut.

Staying put

All of the fund categories mentioned in this article have numerous entrants, so yields will vary from fund to fund. You may be able to find yields around 5% in some funds, whereas core bond funds might be yielding 3% or 2% or even less. Over a lengthy holding period, the difference between compounding a 5% yield and compounding a 2% or 3% yield can be sizable.

Moreover, bond funds tend to buy new bonds because of bond sales, bond redemptions, and new money from investors. If interest rates are rising, fund purchases will bring higher yields, whereas lower yielding bonds are replaced. Again, investors should plan on holding for the long term in order to maximize the value of using bond funds with relatively high yields.

Proceed with caution

High yields generally mean substantial risks, so you may want to mix such bond funds with lower yielding but less volatile bond funds. You could hold funds from every category mentioned here, or you could select only one or two categories to perhaps improve fixed income returns.

If you already hold mutual funds and you're pleased with the results, you might want to see if the fund company has a high-yield fund, an emerging markets bond fund, and so on. Look at the fund's past performance, manager tenure, and investment philosophy before making decisions. The same criteria apply if you're choosing among funds from other companies on your own or if you're working with an adviser.

No tax deductions for business entertaining

The good news is that the TCJA of 2017 lowered corporate tax rates from a graduated schedule that reached 35% to a 21% flat rate. The bad news? Many business expenses are no longer tax deductible. That list includes all outlays that might be considered entertainment or recreation.

As of 2018, tickets to sports events can't be deducted, even if you walk away from the game with a new client

or a lucrative contract. The same is true if you treat a prospect to seats at a Broadway play or take a valued vendor out for a round of golf. Those outlays will be true costs for business owners without any tax relief.

Drilling down

Does that mean that you should drop all your season tickets supporting local teams? Cancel club memberships?

Pack away your putter and your tennis racquet? Before taking any actions in this area, take a breath and crunch some numbers.

Example: In recent years, Luke Watson spent about \$20,000 a year on various forms of entertainment, which his company claimed as a business expense. Indeed, these were valid expenses and helped his LW Corp. grow rapidly.

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Assume that LW Corp. paid income tax at a 34% rate. In 2017 and prior years, business entertaining was only 50% deductible. Thus, LW Corp. deducted \$10,000 (half of Luke's expenses) and saved \$3,400 (34% of \$10,000). With \$3,400 of tax savings and \$20,000 of out-of-pocket costs, Luke's net cost for entertaining was \$16,600 under the law in effect during 2017.

Now suppose that Luke has the same \$20,000 of entertainment costs in 2018 and that those costs would have still been 50% tax deductible at the new 21% tax rate. His tax savings would have been only \$2,100, so the net entertainment cost would have been \$17,900. As it is, under the new law his actual entertainment cost would be the full \$20,000 with no tax benefit.

This example assumes that LW Corp. pays the corporate income tax on its

profits. If Luke operates his business as an LLC or an S corporation, with business income passed through to his personal tax return, the calculation would be different, but the principle would be the same.

Business entertainment has been done mainly with after-tax dollars. Under the new TCJA, you'll entertain clients and prospects solely with after-tax dollars. You should be careful about how this money is spent and judge the expected benefit. Nevertheless, if business entertaining has paid off for your company in the past, it may still prove to be valuable even without tax breaks.

Fine points

Meal expenses associated with operating a trade or business, including employee travel meals, generally continue to be 50% tax

deductible. However, keep in mind that the rules have changed for meals provided for the employer's convenience. Previously, these were 100% deductible if they were excludible from employees' gross income as de minimis fringe benefits. That might have been the cost of providing free drinks and snacks to employees at the workplace. Now outlays for such meals are only 50% deductible and they're scheduled to become nondeductible after 2025.

On the bright side, the new law doesn't affect expenses for recreation, social, or similar activities primarily for the benefit of a company's employees, other than highly compensated employees. So, your business likely can still pay for holiday office parties with pre-tax dollars.

Tax calendar

MAY 2018

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2018. This due date applies only if you deposited the tax for the quarter in full and on time.

May 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.

JUNE 2018

June 15

Individuals. If you are not paying your 2018 income tax through withholding (or will not pay enough tax during the

year that way), pay the second installment of your 2018 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2017. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then, file Form 1040 by October 15.

Corporations. Deposit the second installment of estimated tax for 2018.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in May if the monthly rule applies.



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