2019 CLE in the City
San Francisco, CA

Four BIG Cash Flow Mistakes to Avoid in Divorce

Thursday, August 8, 2019

Speaker:
Justin T. Miller
Highlights of New Tax Code for Family Lawyers

Annual Meeting of ABA – Family Law Section

August 2, 2018

Presented by: Michelle F. Gallagher, CPA/ABV/CFF, and John C. Schumacher, CFA

Description: With the recent tax code changes, attorneys of all varieties are anxious to learn more about how those changes relate to their individual practices. Although it may take several months to understand all the changes completely, this seminar will highlight the important components of the revisions as they relate to family lawyers. In addition to alimony deduction changes, the speakers will discuss the changes to the mortgage interest deductions, charitable and business deductions and highlight other nuances every family lawyer should know.

<table>
<thead>
<tr>
<th>MICHELLE F. GALLAGHER</th>
<th>JOHN C. SCHUMACHER</th>
</tr>
</thead>
<tbody>
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<td>Mobile: 517.930.2948</td>
<td>Mobile: 312.933.2148</td>
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<td>Email: <a href="mailto:jschumacher@adamyvaluation.com">jschumacher@adamyvaluation.com</a></td>
</tr>
</tbody>
</table>

Michelle Gallagher is a nationally-recognized business valuation expert. In addition to serving clients with valuation for tax and other matters, she leads Adamy Valuation’s family law practice.

Her extensive experience includes serving as a trusted consultant, expert witness, mediator, and court-appointed expert. She has testified on behalf of the AICPA at the U.S. Department of Treasury hearing in Washington D.C. related to Proposed Regulations under Internal Revenue Code §2704 in 2016. She also has many years of experience in the professional service areas of accounting, tax, business valuation, litigation support, determination of damages, pension valuation, mediation, divorce consulting, and business advisory services.

Michelle has spoken nationally at AICPA, ABA and AAML conferences, as well as regionally and locally for a variety of business and professional groups on various business valuation and litigation related topics. She was awarded the AICPA FLS Volunteer of the Year Award in 2008, the MICPA Women to Watch Award in 2012, and the AICPA BV Volunteer of the Year Award in 2017.

BA in Accounting, Michigan State University

Certified Public Accountant (CPA)

Certified in Financial Forensics (CFF)
John C. Schumacher is an experienced provider of financial opinions and valuation advisory services to both public and private companies, financial sponsors, trustees and legal counsel on behalf of their clients.

Mr. Schumacher’s industry experience encompasses a broad cross-section of the U.S. and global economy. He has worked with companies ranging from startups to companies engaged in multi-billion dollar transactions. His analyses, opinions, and consulting have been relied upon by decision-makers for a wide range of purposes, including financial reporting, tax, litigation, ESOP, strategic planning, and transaction fairness and solvency.

Prior to joining Adamy Valuation, Mr. Schumacher was a Managing Director at FV & FMV Valuation. Previously he worked in the valuation groups of Stout Risius Ross, Houlihan Lokey and KPMG. Mr. Schumacher started his career in public accounting at a then Big Six accounting firm as an auditor, and later as a management consultant.

MBA, University of Michigan, Ross School of Business, Finance & Corporate Strategy
BSBA, Drake University, Accounting
Chartered Financial Analyst
Certified Public Accountant

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TAX CUTS & JOBS ACT (TCJA)

AN OVERVIEW OF:

- Highlight of Changes - Individuals & Businesses
- Family Law Considerations – Alimony
- Family Law Considerations - Children
- Family Law Considerations - Division of Property
  - Valuation of Closely Held Business
  - Miscellaneous Provisions
- Choice of Legal Entity

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HIGHLIGHT OF CHANGES - INDIVIDUALS & BUSINESSES

Key Changes to Individual Income Tax

- Tax rates: 7 brackets retained; Overall rate decreases (see chart on following page). Breakpoints indexed to inflation after 2018.
- Standard deduction: Nearly doubled
- Personal exemption: Repealed
- SALT Deduction: Limited to $10K (real estate and income taxes)
- Mortgage Interest: Limited to $750k in new acquisition debt; HELOC interest repealed, but in some cases still deductible
- Pease Itemized Deduction Limitation: Repealed
- Child Credit: Doubled and new non-child dependent credit added
- Education: Retained all education credits and expanded use of funds from 529 Plans to now include elementary and high schools
- AMT: Exemption increased; Exemption phaseout threshold substantially increased
- Kiddie Tax: Applicable unearned income now taxed at trust rates vs parents
- Alimony deduction: Repealed after 2018
- Temporary Nature: Most changes to Individuals are set to expire on December 31, 2025

**Individual Comparison & Quick Reference**

<table>
<thead>
<tr>
<th>DEDUCTION</th>
<th>OLD TAX LAW</th>
<th>NEW TAX LAW</th>
</tr>
</thead>
</table>
| Standard Deduction         | Single: $6,350  
                          | MFJ: $12,700  | Single: $12,000  
                          |                                                | MFJ: $24,000  |
| Personal Exemption         | $4,150 per person (high income phase out)      | Repealed                                        |
| State & Local Taxes (SALT) | State Income Tax – full itemized deduction     | Total SALT deduction capped at $10K             |
|                            | City Income Tax – full itemized deduction      |                                                |
|                            | Real Estate Tax – full itemized deduction      |                                                |
| Mortgage/HELOC Interest    | Mortgage: Up to $1M in new mortgage debt (2 homes)  
                          | HELOC: Up to $100K HELOC debt                   | Mortgage: Up to $750K in new mortgage debt (2 homes)  
                          |                                                | HELOC: Repealed                                      |
| Charitable Contrib Limit (cash) | 50%                                             | 60%                                            |
| Misc Itemized Deductions   | Job Expenses: subject to 2% AGI limitation      | Repealed                                        |
|                            | Investment Expenses – subject to 2% AGI limitation | Repealed                                        |
|                            | Professional Fees – subject to 2% AGI limitation | Repealed                                        |
|                            | Other – subject to 2% AGI limitation           | Repealed                                        |
| Pease Limitation           | Reduction in total itemized deductions (high income) | Repealed                                        |
| Alt Min Tax (AMT) Exemption| Single: $54,300  
                          | MFJ: $89,500  | Single: $70,300  
                          |                                                | MFJ: $109,400  |
| AMT Phaseout Threshold     | Single: $120,700  
                          | MFJ: $160,900  | Single: $500,000  
                          |                                                | MFJ: $1,000,000  |
**MFJ Tax Rate Comparison – 2018**

<table>
<thead>
<tr>
<th>INCOME RANGE</th>
<th>PLANNED</th>
<th>NEW</th>
<th>CHANGE</th>
<th>LONG-TERM CAP GAINS &amp; DIVIDENDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 to $19,050</td>
<td>10.0%</td>
<td>10.0%</td>
<td>0.0%</td>
<td></td>
</tr>
<tr>
<td>$19,051 to $77,400</td>
<td>15.0%</td>
<td>12.0%</td>
<td>-3.0%</td>
<td>Taxpayers in the lower tax brackets (10 and 12 percent), the rate remains 0 percent; however, the threshold amount is $77,400 for married filing jointly.</td>
</tr>
<tr>
<td>$77,401 to $156,150</td>
<td>25.0%</td>
<td>22.0%</td>
<td>-3.0%</td>
<td>Taxpayers in the middle tax brackets, 22, 24, 32, and 35 percent, the rate is 15 percent; however the threshold amount is $479,000 for married filing jointly.</td>
</tr>
<tr>
<td>$156,151 to $165,000</td>
<td>28.0%</td>
<td>22.0%</td>
<td>-6.0%</td>
<td></td>
</tr>
<tr>
<td>$165,001 to $237,950</td>
<td>28.0%</td>
<td>24.0%</td>
<td>-4.0%</td>
<td></td>
</tr>
<tr>
<td>$237,951 to $315,000</td>
<td>33.0%</td>
<td>24.0%</td>
<td>-9.0%</td>
<td></td>
</tr>
<tr>
<td>$315,001 to $400,000</td>
<td>33.0%</td>
<td>32.0%</td>
<td>-1.0%</td>
<td></td>
</tr>
<tr>
<td>$400,001 to $424,950</td>
<td>33.0%</td>
<td>35.0%</td>
<td>2.0%</td>
<td></td>
</tr>
<tr>
<td>$424,951 to $480,050</td>
<td>35.0%</td>
<td>35.0%</td>
<td>0.0%</td>
<td></td>
</tr>
<tr>
<td>$480,051 to $600,000</td>
<td>39.6%</td>
<td>35.0%</td>
<td>-4.6%</td>
<td>Taxpayers with income at or above $479,000 for married filing jointly, the rate is capped at 20 percent.</td>
</tr>
<tr>
<td>Over $600,000</td>
<td>39.6%</td>
<td>37.0%</td>
<td>-2.6%</td>
<td></td>
</tr>
</tbody>
</table>

For “Planned,” as planned under prior tax law for 2018.

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**Changes to Business Income Tax**

- Lower corporate rate - 21% (flat rate) on all corporations, including PCs
- Increased immediate & full expensing of certain capital items
- New 20% Qualified Business Income Deduction (QBID) = Lower tax liability for certain pass-through businesses
- Domestic Production Activities Deduction (DPAD) repealed
- Corporate AMT repealed
- Business interest deduction limited
- Business entertainment expenses no longer deductible.
  - Comment: In response, will businesses now change how they characterize entertainment expenses?
- Cash basis of accounting for tax now available to businesses with revenue up to $25M
- Active business losses limited
- NOL deduction modified
- Like-kind exchanges limited to real property
Lower Corporate Tax Rate - C-Corp Tax Rate Comparison

<table>
<thead>
<tr>
<th>TAXABLE INCOME RANGE</th>
<th>OLD</th>
<th>NEW</th>
<th>CHANGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 to $50,000</td>
<td>15.0%</td>
<td>21.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td>$50,001 to $75,000</td>
<td>25.0%</td>
<td>21.0%</td>
<td>-4.0%</td>
</tr>
<tr>
<td>$75,001 to $10,000,000</td>
<td>34.0%</td>
<td>21.0%</td>
<td>-13.0%</td>
</tr>
<tr>
<td>Over $10,000,000</td>
<td>35.0%</td>
<td>21.0%</td>
<td>-14.0%</td>
</tr>
</tbody>
</table>

§179 Depreciation – Increased & Expanded

- Expense allowed up to $1M of tangible personal property
- Expense phased-out if over $2.5M of elected property placed in service
- Expands the definition of qualified tangible personal property and qualified real property eligible to include:
  - tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging
  - improvements to non-residential real property placed in service after the date such property was first placed in service:
    - roofs;
    - heating, ventilation, and air-conditioning;
    - fire protection and alarm systems;
    - and security systems.

Bonus Depreciation Changes

- Immediate deduction at the following declining percentages for eligible property placed in service:
  - 100% 09/27/17 – 12/31/2022
  - 80% in 2023
  - 60% in 2024
  - 40% in 2025
  - 20% in 2026.
- Eligible property expanded to include “used” property
- Reference to qualified improvement property removed
- Bonus depreciation not permitted if using ADS depreciation (see business interest limitation rules)

Note: Some states do not allow Bonus depreciation and adjustments are necessary in calculating State taxable income.
Qualified Business Income Deduction (199A)

Eligible deduction equal to 20% of domestic “qualified business income” from a pass-through entity (LLC/partnership, S-Corp, Sch C, Sch E, Sch F)

Qualified Business Income (QBI)

QBI does not include:

- Any wages you earn as an employee (including reasonable compensation and guaranteed payments)
- Investment income
  - Capital gain/loss
  - Dividend income
  - Interest
  - Any deduction or loss properly allocable to the foregoing

What constitutes “wages” for QBI?

§31.3401(a)

(1) The term “wages” means all remuneration for services performed by an employee for his employer unless specifically excepted under section 3401(a) or excepted under section 3402(e).

(2) The name by which the remuneration for services is designated is immaterial. Thus, salaries, fees, bonuses, commissions on sales or on insurance premiums, pensions, and retired pay are wages within the meaning of the statute if paid as compensation for services performed by the employee for his employer.

(3) The basis upon which the remuneration is paid is immaterial in determining whether the remuneration constitutes wages. Thus, it may be paid on the basis of piecework, or a percentage of profits; and may be paid hourly, daily, weekly, monthly, or annually.

(4) Generally the medium in which remuneration is paid is also immaterial. It may be paid in cash or in something other than cash, as for example, stocks, bonds, or other forms of property. If services are paid for in a medium other than cash, the fair market value of the thing taken in payment is the amount to be included as wages

QBID Amount based on Taxable Income of the taxpayer (not AGI)

- MFJ taxable income < $315,000 = Full QBID eligible, regardless of whether a service business, or not
- MFJ taxable income $315,000 - $415,000 = QBID phase out, regardless of whether a service business, or not
- MFJ taxable income > $415,000
  - Service business = No QBID
  - Non-service business = QBID limited (see formula)
QBID Formula

THE SUM OF:

1. The LESSER OF:
   a. 20% of the taxpayer’s "qualified business income" or
   b. THE GREATER OF:
      i. 50% of allocable share of W-2 wages paid by the business, or
      ii. 25% of allocable share of W-2 wages paid by the business plus 2.5% of allocable share of the unadjusted basis of all qualified property.

2. PLUS:
   a. 20% of qualified REIT dividends
   b. qualified publicly traded partnership income

Overall Limitation: after determining eligible QBID, the deduction is then equal to the LESSER OF:

- the combined "qualified business income" of the taxpayer, or
- 20% of the excess of taxable income minus the sum of any net capital gain

Qualified Business Income Deduction (QBID) – Quick Chart

<table>
<thead>
<tr>
<th>MFJ TAXABLE INCOME</th>
<th>SERVICE</th>
<th>NON-SERVICE</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; $315,000</td>
<td>20% QBI</td>
<td>20% QBI</td>
</tr>
<tr>
<td>$315,000 - $415,000</td>
<td>Phase Out</td>
<td>Phase Out</td>
</tr>
</tbody>
</table>
| > $415,000         | No QBID| QBID is the lesser of
                    |         | • W-2 Wages x 50%
                    |         | • W-2 Wages x 25% + 2.5% of unadjusted basis |

Note: after determining eligible QBI deduction above, an overall limitation applies, where the deduction is equal to the LESSER OF:

• The combined “qualified business income” of the taxpayer, or
• 20% of the excess of taxable income minus the sum of any net capital gain

Service Businesses

- A specified service business means any business activity involving the performance of services by employees or owners in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset of such business is the reputation or skill of one or more of its employees.
- Architecture and engineering were specifically omitted
• Included are the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

**Limited Business Interest Deduction**

• Applies only to businesses with >$25M average gross receipts
• Business interest deduction is limited to 30% of “adjusted taxable income” (basically EBITDA for 2018-2022 and EBIT thereafter)
• Disallowed interest deduction carries forward indefinitely
• Determined at the tax-filer level (e.g. the partnership not the partners would be subject to testing), but it is determined at the consolidated return level for affiliated corporations
• May elect to maintain full deductibility of interest
  o Election requires longer depreciation period for buildings (ADS required)
    ▪ Commercial - 40 years vs 39
    ▪ Residential - 30 years vs. 27.5
  o ADS depreciation election disqualifies use of bonus depreciation

**Business Entertainment & Meals**

• Business Entertainment: No longer deductible
  o Examples include sports tickets, golf outings, and related venues!
• Business Meals
  o Deduction of 50% for food and beverage expenses associated with a trade or business may no longer be the case...tread carefully!
  o For tax years 2018 through 2025, the 50% deduction expands to include expenses incurred for meals furnished to employees for the convenience of the employer.
  o Amounts after 2025 are not deductible.

**Excess Business Losses**

• Applies to noncorporate taxpayers
• Business losses over threshold amount will be considered Excess Business Losses
• Threshold amount for a tax year is $500,000 for MFJ, and $250,000 for other individuals, with both amounts indexed for inflation
• Threshold is applied at the partner or shareholder level
• Excess business losses are not allowed for the tax year, but are instead carried forward and treated as part of the taxpayer's net operating loss (NOL) carryforward in subsequent tax years

**Net Operating Loss (NOL) Deduction**

• Old Law: NOLs generally carried forward 20 yrs/back 2 yrs
  o Old law applies to NOLs generated before 2018
• New Law: For NOLs generated after 2017
  o NOL carryover deduction can offset 80% of taxable income (90% deduction for AMT for individuals)
  o No NOL carrybacks (generally)
• NOLs to be carried forward indefinitely
Like-kind Exchanges

- Old Law: Like-Kind Exchanges available for all property held for investment or use in a trade or business
- New Law: Like-Kind Exchange limited to exchanges of real property
  - Equipment, auto trade-ins, etc. no longer allowed. May be mitigated somewhat by new 100% depreciation deduction rules (i.e., §179 and Bonus).

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ALIMONY CONSIDERATIONS UNDER TCJA

- Alimony
- Reasonable Compensation
  - New double-dip is emerging

Alimony Changes

Alimony payments will no longer be deductible by the payor spouse nor will they be includible in the income of the payee spouse.

According to the Conference Report of Congress on the TCJA, this change achieved fidelity with a ruling by the U.S. Supreme Court, in 1917, in the Gould vs. Gould decision.

Effective date: applies to any divorce or separation instrument as defined in §71(b)(2) executed:

- after December 31, 2018, or
- before December 31, 2018, and modified after that date, if the modification expressly provides that these amendments made by the Act apply to such modification

§71(b)(2) - The term “divorce or separation instrument” means—

- (A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,
- (B) a written separation agreement, or
- (C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse

Comment: If provisions in the alimony agreement or court order are modified after 12/31/2018, the tax treatment that existed when the agreement was first made, or order first entered, will still apply. We are recommending however, the tax treatment under the modified terms be expressly stated as to whether (or not) the new tax law applies and not leave it up for interpretation.

Alimony Alternatives – after 2018

1. Transfer additional retirement assets at pre-tax values as part of property settlement in lieu of alimony
   - Recipient pays income tax on distributions - if under age 59 1/2:
QDRO distributions are not subject to 10% early withdrawal penalty
IRA distributions can be annuitized under Sec 72(t) to avoid 10% penalty

- If payer owns business, consider new cash balance or other aggressive funding plans to replenish retirement accounts and receive current tax deductions on contributions

2. Transfer additional investment account balances at pre-CapGain tax values in lieu of alimony

- Recipient pays taxes when sold and potentially at lower tax rates

3. Offset the present value of otherwise tax deductible/includible alimony with other marital assets

4. For owners of business/real estate, assign a non-voting, assignee, or income-only interest in real estate or business interests in lieu of alimony

- Minority, non-voting, or income-only ownership
- Agreements must include protections for both sides
  - Recipient’s taxable income vs distributions considerations
  - Tying payer’s hands to mandatory distributions may impede other important business decisions

5. Require the non-business owner recipient to enter into a covenant not to compete with the business

6. Consider whether paying wages to recipient, but only if they are actually able to provide services

**Contractual Considerations**

*Divorce Agreements in Process*

Every divorce agreement, prenuptial agreement and post-nuptial agreement in process should address the consequences of the new law, and should be completed prior to the effective date of the new provision if that is preferable, and contemplate the possible change by future legislation.

Add provisions to any agreement in process that if the law is changed as provided in the Act, the agreement can or must be renegotiated (or expressly provide that there will be no renegotiation even if the future amendments to the tax law change the tax effects of payments to be made under the agreement).

Specify in agreements being negotiated before 2019 both the alimony payment amount under the existing law pre-2019 when it can be deducted and the alimony payment amount under the Act in the event the agreement is not concluded in time.

*Pre-2019 Agreements*

Family law attorneys and accountants should put all divorced clients paying or receiving alimony on notice that the agreement lawfully may be modified to bring it under the new law if that proves advantageous for them.

Prior Pre/Post Nup Agreements - review agreements and address prior alimony provisions and whether to proactively enter into a postnuptial agreement in order to confront the issue.
Is the tax law change considered a substantial modification in circumstances warranting support modifications??

Future possibility of repeal or changes to New Tax Law

What will happen, should that occur, to property settlement agreements that are executed while the alimony deduction was eliminated?

Should matrimonial practitioners risk complicating the divorce agreement more by trying to contemplate the possibility of future legislative change at a time when the sea-change of nondeductible alimony has not yet been digested?

If an agreement to renegotiate the provision if the law changes is included, what will be the consequences?

If the agreement provides for the renegotiation of the alimony provision, when it comes time to do so, will it open the floodgate to renegotiate other nonrelated terms in order to get the deal done?

Reasonable Compensation Considerations

Increased emphasis on compensation planning for entities where the QBID limitations are in play

- “greater of 50% of W-2 wages or 25% of W-2 wages, plus 2.5% of depreciable assets”

Potential for planning opportunities with closely held C corporations where the goal is to expose more income to the new 21% rate

Methods and precedents to determine and support reasonable compensation for owner-employees has not changed

- Complex trade offs between optimizing TCJA impact, employment taxes, pension plan thresholds, and expense reimbursements
## Compensation & QBID Scenarios

<table>
<thead>
<tr>
<th>Summary</th>
<th>NoComp</th>
<th>Soc Sec</th>
<th>PensMax</th>
<th>Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income Before QBID</td>
<td>$800,000</td>
<td>$800,000</td>
<td>$800,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>QBID</td>
<td>(80,000)</td>
<td>(124,260)</td>
<td>(95,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$720,000</td>
<td>$675,740</td>
<td>$705,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>Federal Income Tax Tables *</td>
<td>$205,779</td>
<td>$189,403</td>
<td>$200,229</td>
<td>$216,879</td>
</tr>
<tr>
<td>Effective Federal Tax Rate *</td>
<td>28.6%</td>
<td>28.0%</td>
<td>28.4%</td>
<td>28.9%</td>
</tr>
<tr>
<td>Total Business Income</td>
<td>$750,000</td>
<td>$750,000</td>
<td>$750,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>Comp/Business Income</td>
<td>0.0%</td>
<td>17.2%</td>
<td>36.7%</td>
<td>66.7%</td>
</tr>
<tr>
<td>QBID/Business Income</td>
<td>10.7%</td>
<td>16.6%</td>
<td>12.7%</td>
<td>6.7%</td>
</tr>
</tbody>
</table>

* Excluding Payroll/SE Taxes

## Emerging Issues

New Double-Dip: Family law attorneys will need to understand the interplay of compensation, QBID, and business valuation.

Business owner spouses will compensate him/herself at levels that maximize the QBID which could potentially impact business values and income available for support if not addressed.

Will you see more business owners give partial ownership to spouse to maximize QBID?

- This tax deduction/savings likely disappears in anticipation of divorce

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**FAMILY LAW CONSIDERATIONS - CHILDREN**

- Child tax credits
- IRC section 529 plans
- Kiddie tax

**Exemptions & Credits**

- The new law fully eliminates Personal Exemptions
- The new law increases the child credit from $1,000 to $2,000 per qualifying child
- The new law adds a $500 credit for other family dependents
- Income phaseouts have substantially increased ($400,000 for MFJ and $200,000 for others)
### Child/Non-Child Credits Summary (all MFJ)

<table>
<thead>
<tr>
<th>CREDIT</th>
<th>OLD TAX LAW</th>
<th>NEW TAX LAW</th>
</tr>
</thead>
<tbody>
<tr>
<td>Child Credit (dependents age &lt;17)</td>
<td>$1,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Child Credit-Refundable Amount</td>
<td>$1,000</td>
<td>$1,400</td>
</tr>
<tr>
<td>Non-Child Credit [Non-refundable] (dependents age 17+)</td>
<td>$0</td>
<td>$500</td>
</tr>
<tr>
<td>Phase-out starting point</td>
<td>$110,000</td>
<td>$400,000</td>
</tr>
</tbody>
</table>
## Dependency Exemptions and Child Related Tax Credits - Quick Reference Table

<table>
<thead>
<tr>
<th></th>
<th>Age</th>
<th>Qualifying Child Relationship</th>
<th>Residence</th>
<th>Support</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dependency Exemption</strong></td>
<td><strong>&lt;19, or 24 if full time student</strong></td>
<td>Son or Daughter, Stepson/Stepdaughter</td>
<td>Child resides with the taxpayer for &gt; one-half of the year.</td>
<td>Qualifying child cannot provide more than one-half of their own support for the year.</td>
</tr>
<tr>
<td><strong>Child Tax Credit</strong></td>
<td><strong>&lt;17</strong></td>
<td>Descendants of sons, daughters, stepsons, or stepdaughters</td>
<td>Exceptions include temporary absences due to education, illness, vacation or military service.</td>
<td></td>
</tr>
<tr>
<td><strong>Dependent Care Credit</strong></td>
<td><strong>&lt;13</strong></td>
<td>Individuals whom are legally adopted or a foster child placed with the taxpayer by an authorized agency or by court decree, order or judgment.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Tuition Credits or Deductions</strong></td>
<td><strong>&lt;19, or 24 if full time student.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Earned Income Credit</strong></td>
<td><strong>&lt;19, or 24 if full time student.</strong></td>
<td></td>
<td>Child must have the same principal place of abode in the U.S. as the taxpayer for &gt; one-half of the year.</td>
<td>Support test does not apply for EIC</td>
</tr>
</tbody>
</table>

The dependent or child must be a citizen or resident of the U.S. or a citizen or resident of a country contiguous to the U.S.

(a) The exemption carries with it the right to use the child credit as well as tuition credits/deductions.
(b) No age limit for totally and permanently disabled persons.

c) The dependent care credit is only available to the parent who has custody of the child for the greater part of the year. Form 8332 has no effect on the ability to claim the credit for child care expenses.

d) Only the custodial parent can claim the EIC. The non-custodial parent would not pass the residence test.

### Dependency Exemptions and the Treatment of Child Related Attributes in Divorce

**Dependency exemption**

- Custodial parent is entitled to the dependency exemption – IRC §152, Mahrer vs. Commissioner, T.C. Memo 2003-85.
- Parents, together or separately, must provide at least one-half of the child's support.
- Two exceptions to the general rule that the custodial parent is entitled to the dependency exemption.
  1. A multiple support agreement is in place - §152(d)(3)
  2. The custodial parent relinquishes the rights to the exemption (either annually or permanently) - §152(e)(2)(A).

  Note: Divorced parents are allowed to trade exemptions back and forth using IRS form 8332.

**Tiebreaker Rules** - If two or more taxpayers qualify to claim tax benefits related to a single qualifying child, a series of "tiebreaker" rules exist to determine who is eligible for the tax benefits.

- If one individual is a parent and the other is not, the parent is entitled to the benefit.
- If both taxpayers are parents, the parent with whom the qualifying child resided most during the year is the tiebreaker parent.
- If the child resided with the parents equal time throughout the year, the parent with the greater AGI is entitled to the benefits.
- If neither individual is a parent, the individual with the greater AGI is entitled to the benefits.

**Head of Household Filing Status** - To qualify as HOH, a taxpayer must:

- Be unmarried - you are considered unmarried if you were legally separated on December 31 or if your spouse did not live in your home for the last six-months of the year.
- Pay more than one-half the cost of maintaining a household which is the principal domicile for a qualifying child or an individual that otherwise qualifies for a dependency exemption.
Impact to Family Law

Divorce Agreements in Process

Dependent children may be worth “fighting” for with higher credit amounts available and higher income phaseouts

Although the personal exemption deduction is gone, the new credit amounts may be a bigger benefit or reasonable offset

Exemption release formalities yet to be determined (IRS Form 8332)

Does it matter if the provision sunsets at the end of 2025?

Prior Divorce Agreements

Tax benefit was likely negotiated as a trade-off for another concession.

Is there a basis to revisit or adjust the agreement?

• likely the value involved would not support the cost of reopening the agreement

Does it matter if the provision sunsets at the end of 2025?

Impact of 529 Plan Changes

The new law changes 529 plans in significant ways that most likely no matrimonial settlement agreements have anticipated.

The qualified expenses under 529 plans will now also include elementary and high school education of up to $10,000 per year.

Permissible distributions can also be made to religious educational institutions.

Prior divorce agreements most likely failed to include provisions requiring that 529 funds be reserved for payment of college expenses so the use of 529 funds now for elementary or high school could undermine original divorce agreements and dissipate college funds.

non-title owner should exercise any rights he or she may have to review the account statements to track how the funds are being spent and to consult with his or her lawyer about taking action to address the issue before it may be too late to prevent dissipation of the funds

What happens if the divorce agreement is silent or ambiguous as to the application of the 529 funds?

What if one ex-spouse was obligated to pay for private pre-college education and the agreement is not clear on limiting 529 plans for college?

Can that spouse distribute funds from a 529 plan to pay his or her obligations for elementary school?

What if that dissipates the funds intended for college?

Review existing divorce agreements in order to ascertain whether the agreement specified college-only expenses be paid from a 529 plan and whether that would suffice to restrict the spouse account owner from using funds earlier.
Kiddie Tax Changes

Old Law: Unearned income over $2,100 of a dependent child under age 24 was subject to tax at parent’s tax rates

New Law: TCJA taxes a dependent child’s earned income at tax rates for single individuals and taxes unearned income over $2,100 at trust and estate tax rates

Favorable capital gain and dividend tax rates apply

The top tax bracket starts at $12,500 of taxable income for estates and trusts

Dependent child standard deduction is $250 plus earned income up to the maximum single standard deduction ($12,000 for 2018)

Impact of Kiddie Tax Changes

Children subject to the Kiddie Tax will now file separate tax returns (not included on parents return)

If investment income or activity is down on the parents’ tax returns, consider requesting children’s tax returns or inquire about new trusts to see if investments have been shifted recently

FAMILY LAW CONSIDERATIONS – DIVISION OF ASSETS

- Valuation of closely-held business
- Real estate interest deduction

Business Valuation Considerations

Standard of value and methodology issues

- Who is the hypothetical willing buyer?

Cash flow method considerations

Cost of capital and multiples

Tax affecting pass-through entities and the QBID

Reasonable compensation

Use of historical data

- Market based comparable transaction method multiples
- Equity Risk Premium (historical/supply side)

C Corp BV Example

Income approach using single period capitalization

Reduced tax rate utilized

Capital expenditures = Depreciation
No interest or loss limitations

Cost of capital adjusted for tax rate and capital structure changes

**C Corp BV Example – Tax Rate**

<table>
<thead>
<tr>
<th>TAX RATE CHANGE – BV EXAMPLE</th>
<th>BEFORE TCJA</th>
<th>AFTER TCJA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Corporate Rate</td>
<td>35.0%</td>
<td>21.0%</td>
</tr>
<tr>
<td>State Corporate Tax Rate (~average)</td>
<td>6.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Federal Tax Deduction (35% &amp; 21%)</td>
<td>-2.1%</td>
<td>-1.3%</td>
</tr>
<tr>
<td>Adjusted State Corporate Tax Rate</td>
<td>3.9%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Combined Federal &amp; State Corporate Rate</td>
<td>38.9%</td>
<td>25.7%</td>
</tr>
</tbody>
</table>

**C Corp BV Example – Cost of Capital**

<table>
<thead>
<tr>
<th>COMPONENTS OF CAPITALIZATION RATE</th>
<th>BEFORE TCJA</th>
<th>AFTER TCJA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Rate*</td>
<td>5.0%</td>
<td>20.0%</td>
</tr>
<tr>
<td>Debt Rate</td>
<td>-2.0%</td>
<td>-1.3%</td>
</tr>
<tr>
<td>Tax Deduction (39% &amp; 26%)</td>
<td>3.1%</td>
<td>3.7%</td>
</tr>
<tr>
<td>Equity Weighting</td>
<td>65.0%</td>
<td>70.0%</td>
</tr>
<tr>
<td>Debt Weighting</td>
<td>35.0%</td>
<td>30.0%</td>
</tr>
<tr>
<td>Cost of Capital</td>
<td>14.1%</td>
<td>15.1%</td>
</tr>
<tr>
<td>Long-term Growth Rate*</td>
<td>-3.0%</td>
<td>-3.0%</td>
</tr>
<tr>
<td>Capitalization Rate</td>
<td>11.1%</td>
<td>12.1%</td>
</tr>
</tbody>
</table>
C Corp BV Example – Equity Value

<table>
<thead>
<tr>
<th></th>
<th>BEFORE TCJA</th>
<th>AFTER TCJA</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EBIT</strong></td>
<td>$100,000</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td><strong>Tax Deduction (39% &amp; 26%)</strong></td>
<td>(39,000)</td>
<td>(26,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Debt Free Net Income</strong></td>
<td>61,000</td>
<td>74,000</td>
<td></td>
</tr>
<tr>
<td><strong>Capital Expenditures</strong></td>
<td>(25,000)</td>
<td>(25,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Depreciation</strong></td>
<td>25,000</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td><strong>Working Capital</strong></td>
<td>(5,000)</td>
<td>(5,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Debt Free Cash Flow</strong></td>
<td>56,000</td>
<td>69,000</td>
<td></td>
</tr>
<tr>
<td><strong>Capitalization Rate</strong></td>
<td>11.0%</td>
<td>12.0%</td>
<td>Increase</td>
</tr>
<tr>
<td><strong>Enterprise Value</strong></td>
<td>$509,000</td>
<td>$575,000</td>
<td>13.0%</td>
</tr>
<tr>
<td><strong>Debt</strong></td>
<td>(250,000)</td>
<td>(250,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Equity Value</strong></td>
<td>$259,000</td>
<td>$325,000</td>
<td>25.5%</td>
</tr>
</tbody>
</table>

**Tax Affecting Pass-Through Entities & QBID**

Does the pass-through entity (“PTE,” i.e., *S-corporations and Partnerships*) premium still exist?

TCJA calls into question the issue of a PTE premium ... but not necessarily the controversy over whether or not to tax-affect PTE earnings for valuation purposes.

Some “tax-affecting” methods are based on harmonizing effective tax rate differentials between entities (Delaware Open Radiology vs. Kessler)

Does the QBID put most business entities on the same playing field?

**Tax Affecting Pass-Through Entities & QBID**

TCJA immediately reduces tax, increasing income and cash flow...but it sunsets.

Are single-period capitalized cash flow methods still appropriate?

Long-term cash flow projections will eventually bump up against the sunset date: Should DCF models be taken out to 2025?

Should a second discount rate be used to calculate the terminal value?

How should we deal with these added complexities in an already controversial area of valuation? Who will understand (who will care)?

**QBID’s Impact on Valuation Theory**

How should appraisers deal with the applicability and calculation of the QBID in valuation?

- Remember the 9% DPAD deduction (now repealed)...how was that historically treated in BV, if at all? Is the QBID the same?
FMV assumes a “hypothetical willing buyer & seller”... How do we reconcile QBID’s impact, if any, across the spectrum of hypothetical buyers?

Does the temporary nature of the QBID have any impact?

**QBID Example: Non-Service Business**

Taxpayer is married, $250,000 in business income, earned $500,000 in wages and $100,000 in other income, and $50,000 in itemized deductions. Taxpayer’s business paid $620,000 in wages and has qualified fixed assets with an unadjusted basis of $2,000,000.

<table>
<thead>
<tr>
<th>QBI DEDUCTION</th>
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<tbody>
<tr>
<td><strong>Business Income (QBI)</strong></td>
</tr>
<tr>
<td><strong>Wages</strong></td>
</tr>
<tr>
<td><strong>Other Income</strong></td>
</tr>
<tr>
<td><strong>AGI</strong></td>
</tr>
<tr>
<td><strong>Less: Standard Deduction</strong></td>
</tr>
<tr>
<td><strong>Taxable Income</strong></td>
</tr>
<tr>
<td>QBI Deduction Equals the Lesser of:</td>
</tr>
<tr>
<td>(a) 20% x 250,000 QBI</td>
</tr>
<tr>
<td>(b) Greater of:</td>
</tr>
<tr>
<td>50% x 620,000 W-2 wages</td>
</tr>
<tr>
<td>25% x 620,000 W-2 wages + 2.5% x $2M</td>
</tr>
<tr>
<td><strong>Overall Limitation</strong></td>
</tr>
<tr>
<td>20% x 800,000 taxable income</td>
</tr>
</tbody>
</table>

Market Transaction Based Methods of Valuation Won’t Escape Impact from TCJA:

Tax rate changes won’t directly affect EBITDA or EBIT earnings streams since they are pre-tax.

However, some of the management decisions identified above may change those earnings streams.

EBITDA multiples will likely rise as a result of increased values caused by enhanced after-tax cash flows.

Multiples derived from comparable company transactions occurring before TCJA may understate value.
## Financial Statements - Book vs. Tax

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## Mortgage Interest Changes

*Old Law:*

Types of Qualified Residence Interest (QRI)

1. Qualified Acquisition Indebtedness (QAI) – debt secured by the home and incurred to buy, build, or remodel *that* home

2. Home Equity Indebtedness (HEI) – debt secured by the home but not *necessarily* incurred to buy, build, or remodel *that* home
   - HEI allowed for any purpose: payoff credit cards, college/education, buy a car, etc.
   - Note: Remodeling costs funded by HEI considered QAI if the remodel was on that home and HEI if done on another home

QRI deduction limits

1. Interest on QAI up to $1,000,000 for primary and secondary homes (combined)

2. Interest on HEI up to $100,000 for primary and secondary homes (combined)

Therefore, interest from up to $1,100,000 of debt secured by homes could be deductible
New Law:

Effective Date

- Applies to new acquisition debt incurred on or before December 15, 2017
- Exception: For a taxpayer who entered into a written binding contract before Dec. 15, 2017 to close on the purchase of a principal residence before Jan. 1, 2018, and who purchased that residence before Apr. 1, 2018, the old law applies

Types of Personal Residence Debt

1. Qualified Acquisition Indebtedness (QAI) – debt secured by the home and incurred to buy, build, or remodel that home (no change in QAI definition)
2. Home Equity Indebtedness (HEI) – not deductible except QAI qualifying portion

Qualified Residence Interest (QRI) deduction limitations

Interest on QAI up to $750,000 for primary and secondary homes (combined)

- includes mortgage and HELOC balances used to buy, build, or remodel the home secured by the debt

Transition Rules

- The interest on up to $1,000,000 QAI for principal and second residence mortgages (combined) continues to be deductible for existing mortgages at December 15, 2017.
- Existing mortgages can be refinanced and the interest can continue to be deductible.
  - In the case of any indebtedness which is incurred to refinance indebtedness, such refinanced indebtedness shall be treated as incurred on the date that the original indebtedness was incurred to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.
  - Refinanced balance and equity taken/additional funds used to remodel that home
- After 2017, HELOC interest related to non-QAI purposes will no longer be deductible

Family Law Impact of Mortgage Interest Changes

Refinancing of mortgages and HELOCs are very common in divorce

For future tracking purposes, the party retaining the home and related debt(s) should obtain the following records:

- Identify all mortgage and HELOC balances as of 12/15/2017 and breakdown by
  - QAI Mortgage balances
  - QAI HELOC balances – funds used to buy, build, or remodel the home securing that HELOC
o HEI HELOC balances – funds NOT used to buy, build, or remodel the home securing that HELOC

• If existing mortgages are refinanced and mortgage debt is increased, breakdown the newly refinanced debt balance by
  o Portion related to QAI mortgages in place at 12/15/2017
  o Portion related to QAI mortgages on new acquisitions after 12/15/2017
  o Portion of new debt related to QAI (remodeling/home improvements)
  o Portion of new debt related to Non-QAI purposes (other personal uses)

****************

CHOICE OF LEGAL ENTITY CONSIDERATIONS

Overview

Although taxes do matter, the entity choice decision is NOT all about tax rate differences!

Long-term decision

• Partnership converting to C-Corp is essentially a permanent decision – no tax efficient option to switch back.

• S-Corp converting to C-Corp is essentially a 10-year decision - S Corporations cannot revert back to C for 5-years. After that, there is another 5-year period they are subject to additional taxes for built-in gains on re-conversion.

What are the chances future legislation could change rates again?
Effective Tax Rate Differences

Depends on business distributions and ownership holding period

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Other Considerations

Will business qualify for the pass-through deduction (QBID)?

What are the owner’s plans for exiting the business

- PTE offer certain advantages
- C-Corp double taxation on sale and distribution of proceeds to owners

State tax considerations

- Entity level State business tax calculations often differ between C-Corps and PTEs
- No deduction limitation for C-Corp
- Deduction now limited for individual owner of PTE

Income and distributions to owners

- C-Corp/S-Corp wages & Pship guaranteed payments – flexible (QBID considerations)
- C-Corp dividends – based on pro-rata ownership (double taxation considerations)
- S-Corp allocated income & distributions - based on pro-rata ownership
- Pship allocated income & distributions – specific allocations allowed
Does business have foreign earnings - new tax law denies PTE’s many special deductions and exclusions on foreign tax rules that C-Corp enjoy

Does the business have current NOL’s or expect losses in the future

***************

THANK YOU
Conference Agreement

The conference agreement follows the Senate amendment.

8. Repeal of deduction for alimony payments and corresponding inclusion in gross income (sec. 1309 of the House bill and secs. 61, 71, and 215 of the Code)

Present Law

Alimony and separate maintenance payments are deductible by the payor spouse and includible in income by the recipient spouse.\(^{231}\) Child support payments are not treated as alimony.\(^{232}\)

House Bill

Under the House bill, alimony and separate maintenance payments are not deductible by the payor spouse. The House bill repeals the Code provisions that specify that alimony and separate maintenance payments are included in income. Thus, the intent of the provision is to follow the rule of the United States Supreme Court’s holding in Gould v. Gould.\(^ {233}\) in which the Court held that such payments are not income to the recipient. Income used for alimony payments is taxed at the rates applicable to the payor spouse rather than the recipient spouse. The treatment of child support is not changed.

Effective date.—The provision is effective for any divorce or separation instrument executed after December 31, 2017, or for any divorce or separation instrument executed on or before December 31, 2017, and modified after that date, if the modification expressly provides that the amendments made by this section apply to such modification.

Senate Amendment

No provision.

Conference Agreement

The conference agreement generally follows the House bill. However, the conference agreement delays the effective date of the provision by one year. Thus, the conference agreement is effective for any divorce or separation instrument executed after December 31, 2018, or for any divorce or separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by this section apply to such modification.

\(^{231}\) Secs. 215(a), 61(a)(5) and 71(a).

\(^{232}\) Sec. 71(c).

\(^{233}\) 245 U.S. 151 (1917).
GOULD v. GOULD.

ERROR TO THE SUPREME COURT OF THE STATE OF NEW YORK.

No. 41. Submitted November 8, 1917.—Decided November 19, 1917.

Alimony paid monthly to a divorced wife under a decree of court is
not taxable as "income" under the Income Tax Act of October 3,
1913, 38 Stat. 114, 166.
In the interpretation of taxing statutes it is the established rule not
to extend their provisions, by implication, beyond the clear import
of the language used, or to enlarge their operations so as to embrace
matters not specifically pointed out. Doubts are resolved against
the Government.

The case is stated in the opinion.
Opinion of the Court.

Mr. Martin W. Littleton and Mr. Owen N. Brown for
plaintiff in error.

Mr. John L. McNab for defendant in error.

Mr. Justice McReynolds delivered the opinion of the
court.

A decree of the Supreme Court for New York County
entered in 1909 forever separated the parties to this pro-
ceeding, then and now citizens of the United States, from
bed and board; and further ordered that plaintiff in error
pay to Katherine C. Gould during her life the sum of three
thousand dollars ($3,000.00) every month for her support
and maintenance. The question presented is whether
such monthly payments during the years 1913 and 1914
constituted parts of Mrs. Gould's income within the in-
tendment of the Act of Congress approved October 3,
1913, 38 Stat. 114, 166, and were subject as such to the
tax prescribed therein. The court below answered in
the negative; and we think it reached the proper conclu-
sion.

Pertinent portions of the act follow:

"SECTION II. A. Subdivision 1. That there shall be
levied, assessed, collected and paid annually upon the
entire net income arising or accruing from all sources in
the preceding calendar year to every citizen of the United
States, whether residing at home or abroad, and to every
person residing in the United States, though not a citizen
thereof, a tax of 1 per centum per annum upon such in-
come, except as hereinafter provided; / . . .

"B. That, subject only to such exemptions and de-
ductions as are hereinafter allowed, the net income of a
taxable person shall include gains, profits, and income
derived from salaries, wages, or compensation for personal
service of whatever kind and in whatever form paid, or
from professions, vocations, businesses, trade, commerce,
or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent: . . . ."

In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen. United States v. Wigglesworth, 2 Story, 369; American Net & Twine Co. v. Worthington, 141 U. S. 468, 474; Benziger v. United States, 192 U. S. 38, 55.

As appears from the above quotations, the net income upon which subdivision 1 directs that an annual tax shall be assessed, levied, collected and paid is defined in division B. The use of the word itself in the definition of "income" causes some obscurity, but we are unable to assert that alimony paid to a divorced wife under a decree of court falls fairly within any of the terms employed.

In Audubon v. Shufeldt, 181 U. S. 575, 577, 578, we said: "Alimony does not arise from any business transaction, but from the relation of marriage. It is not founded on contract, express or implied, but on the natural and legal duty of the husband to support the wife. The general obligation to support is made specific by the decree of the court of appropriate jurisdiction. . . . Permanent alimony is regarded rather as a portion of the husband's estate to which the wife is equitably entitled, than as strictly a debt; alimony from time to time may be regarded as a portion of his current income or earnings; . . . ."
The net income of the divorced husband subject to taxation was not decreased by payment of alimony under the court's order; and, on the other hand, the sum received by the wife on account thereof cannot be regarded as income arising or accruing to her within the enactment. The judgment of the court below is 

*Affirmed.*