WRMarketplace

An AALU Washington Report

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TOPIC: Decoding Tax Reform: Alimony – Breaking Up is Hard(er) To Do.

MARKET TREND: With enactment of the 2017 tax reform legislation (the "2017 Tax Act"), divorce may have just gotten more expensive in the future.

SYNOPSIS: For 75 years, alimony payments have been allowed as an income tax deduction for the paying spouse and treated as taxable income to the recipient spouse. The 2017 Tax Act, however, significantly changes this tax treatment for divorce decrees and other agreements for support or maintenance incident to a divorce (collectively referred to as "marital support agreements" or "MSAs") finalized or entered into after 2018. The paying spouse will no longer be able to deduct the alimony payment, and the recipient spouse will no longer be taxed on the receipt. While this change appears straight forward at first glance, it could have far-reaching implications, including how alimony payments are calculated and how divorce decrees, MSAs, and other marital agreements are negotiated or modified.

TAKE-AWAYS: Advisors who assist clients pre- and post-divorce need to understand the impact that the elimination of the deduction for alimony payments will have on various aspects of their clients' wealth and legacy planning, including the preparation of premarital and post-marital agreements. The elimination of the alimony deduction does not sunset.

For many individuals, one of the most significant changes made by the 2017 Tax Act[1] to the Internal Revenue Code ("**Code**") is the elimination of the deduction for alimony payments (sometimes referred to as "**spousal support**"). The 2017 Tax Act will treat alimony payments under post-2018 divorce decrees and MSAs like child support payments, meaning that alimony payments will no longer be deductible by the paying spouse and the recipient spouse will receive the payments completely tax-free. As opposed to most individual tax law changes, this one does not sunset. Because alimony is usually paid by the spouse in a higher income tax bracket, not only will the funds used to pay spousal support be taxed at higher rates, but more income will be reported and taxed as there is a significant gap between the number of taxpayers claiming the deduction and those taxpayers reporting alimony as income on their tax returns.

CURRENT LAW

Currently, the spouse who pays alimony deducts the payments[2] and the spouse who receives the payments is taxed on them as income.[3] In theory, since the spouse in a higher income tax bracket generally pays alimony to a spouse in a lower income tax bracket, less money is paid to the federal government and more funds are available to support the family unit. This tax regime for alimony continues to apply to payments made pursuant to divorce decrees and MSAs finalized or entered into on or before December 31, 2018.

> *Example 1*: H and W entered into an MSA on June 13, 2017. Under the terms of the MSA, H pays W $10,000 per month in alimony, for a total of $120,000 per year. H's top marginal federal income tax rate for 2018 is 37% while W's top marginal income tax rate is 24%. Under current law, H's ability to deduct the $120,000 alimony payment will save him up to $44,400 in federal income taxes, leaving a net outlay for alimony payments of $75,600. On the other hand, assuming W has no other income, she will pay about $20,210 in federal income taxes, leaving her with a net of $99,790. By shifting the income tax burden to W, H and W will have a net income tax savings of approximately $24,190.

Current law also provides for the use of so-called "**alimony trusts**" to achieve similar results. In this type of arrangement, the paying spouse establishes and funds a trust for the benefit of the payee spouse, with the trust to be used as the source of alimony payments. The transfer to the trust, which is incident to a divorce, is not subject to gift tax.[4] Although the paying spouse cannot claim the alimony deduction for the income generated by the trust, the payee spouse is taxed on the trust's income but not the portion of the payment that constitutes trust principal.[5] Alimony trusts allowed spouses to circumvent some of the restrictions imposed on normal alimony payments, such as the requirement that payments not continue beyond the death of the payee spouse.

WHAT'S CHANGED?

For divorce decrees and MSAs finalized or entered into after December 31, 2018, the tax burden for alimony payments will shift to the paying spouse, since the paying spouse will not be able to deduct the payments and the payee spouse will not report the payments as income.

> *Example 2*: Assume the same facts as Example 1, except that H and W enter into an MSA on February 5, 2019. Under the new tax provisions, H cannot deduct the $120,000 alimony payments on his income tax return. So H will have an additional outlay of $44,400 in federal income taxes, for a total cost to H of $164,400, while W receives the entire $120,000 tax free. The federal government will receive an additional $24,190 in tax revenue as compared to alimony payments for which the deduction is allowed.

The 2017 Tax Act also changes the taxation of future alimony trusts by deleting Code §682 (which taxes income from an alimony trust to the payee spouse, rather than the payor spouse).

Note that modifications made after December 31, 2018 to divorce decrees and MSAs finalized or entered into on or before that date will not change the tax treatment of alimony payments unless the couple specifically agrees that the new tax provisions should apply.[6]

REAL WORLD IMPLICATIONS

The elimination of the alimony deduction could have far-reaching and unintended consequences.

- Elimination of the deduction will change how property settlements and alimony agreements are negotiated.
  - The ability to use alimony payments as a deduction generally is taken into account when negotiating alimony payments. Placing the tax burden for such payments on the payee spouse, who typically is in a lower tax bracket, made it easier for the paying spouse to agree to higher payments and generally resulted in more funds being available for the family unit.
  - Under the new tax laws, the deduction will no longer be a factor in negotiating alimony payments, likely making settlement discussions more prolonged and contentious, with high alimony payments being harder to sell to the paying spouse. Elimination of the deduction could very well result in lower overall spousal support payments, imposing a higher financial burden on both spouses.

- Spousal support payments will no longer need to qualify as "alimony" under the Code to be eligible for the deduction,[7] which may open the door for the use of annuities to fund alimony payments and life insurance to support alimony payments beyond the death of the paying spouse. Spouses also may change strategies regarding how to divide up their assets, potentially front-loading payments or making other property concessions in lieu of alimony payments.

- Spouses who anticipate being required to pay alimony may push to finalize divorces or MSAs before the end of 2018, while a spouse who will receive the benefit of the new tax provisions may try to prolong the divorce proceedings until next year to obtain tax-free alimony payments, creating additional discord between the parties.

- The upcoming change could potentially incentivize new divorce filings in 2018 to secure the deduction, including for spouses who might otherwise have tried to work things out.

- A number of states use a formula to determine alimony payments. Many such formulas are based in part on the ability of the paying spouse to deduct alimony payments. It is unknown whether these states will modify their formulas in light of the new tax law. In the meantime, elimination of the deduction may provide some family court judges with a basis for deviating from the formula.

- Elimination of the deduction also will impact current and future premarital and post-marital agreements that provide for support payments in the event of a divorce. Existing premarital and post-marital agreements will need to be reviewed and future premarital and post-marital agreements will need to reflect the new tax law.

TAKE-AWAYS

Advisors who assist clients pre- and post-divorce need to understand the impact that the elimination of the deduction for alimony payments will have on various aspects of their clients' wealth and legacy planning strategies, including the preparation of premarital and post-marital agreements. The elimination of the alimony deduction does <u>not</u> sunset.

NOTES

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[1] Pub. L. No. 115-97 (H.R. 1).

[2] Code §215(a). To qualify for the deduction, the alimony must be made and cash and (i) received by a spouse under a divorce or separation instrument, (ii) the divorce or separation instrument cannot preclude the payment from being allowed as a deduction, (iii) if the spouses are legally separated under a decree of divorce or separate maintenance then the spouses cannot be members of the same household, and (iv) liability for the payments cannot extend for any period beyond the death of the payee spouse. Code §71(b)(1).

[3] Code §71(a).

[4] Code §2516.

[5] Code §682.

[6] Pub. L. No. 115-97 (H.R. 1), Sec. 11051(c)(2).

[7] *Id*. at 2.