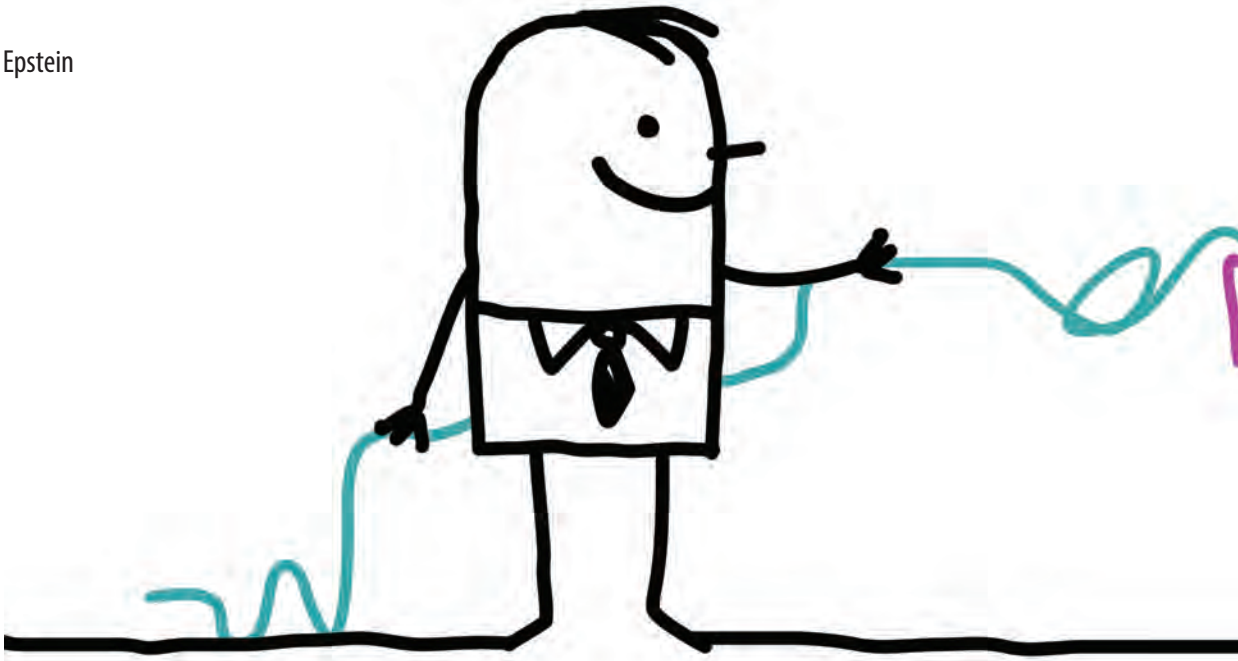
Alimony Unraveled

By Phyllis Horn Epstein



The loss of the alimony deduction creates a seismic change in matrimonial law.

Alimony payments have been a tax deduction for nearly 75 years. That ended with the new Tax Cuts and Jobs Act of 2017. Effective Jan. 1, 2019, alimony will no longer be deductible for the payor under Internal Revenue Code (IRC) §215(a) and will no longer be income to the recipient as it had been under IRC §61(a)(8). Until the end of 2018, deductible alimony must be made in cash related to 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.

One can only speculate about Congress' motivation for getting rid of the alimony deduction. My guess, or hope, is that this change was motivated not by politics but by the alimony reporting discrepancies reported by the Treasury Inspector General for Tax Administration in 2014 showing that of the 567,887 returns filed in 2011 claiming an alimony deduction, there were 266,190 corresponding returns that failed to show alimony income. In other words, nearly half of the returns with an alimony deduction did not have a corresponding return showing alimony income. The alimony discrepancy for 2011 was $2.3 billion. The data is either symptomatic of fraudulently claimed alimony deductions or an underreporting of alimony income by recipients. We don't know.

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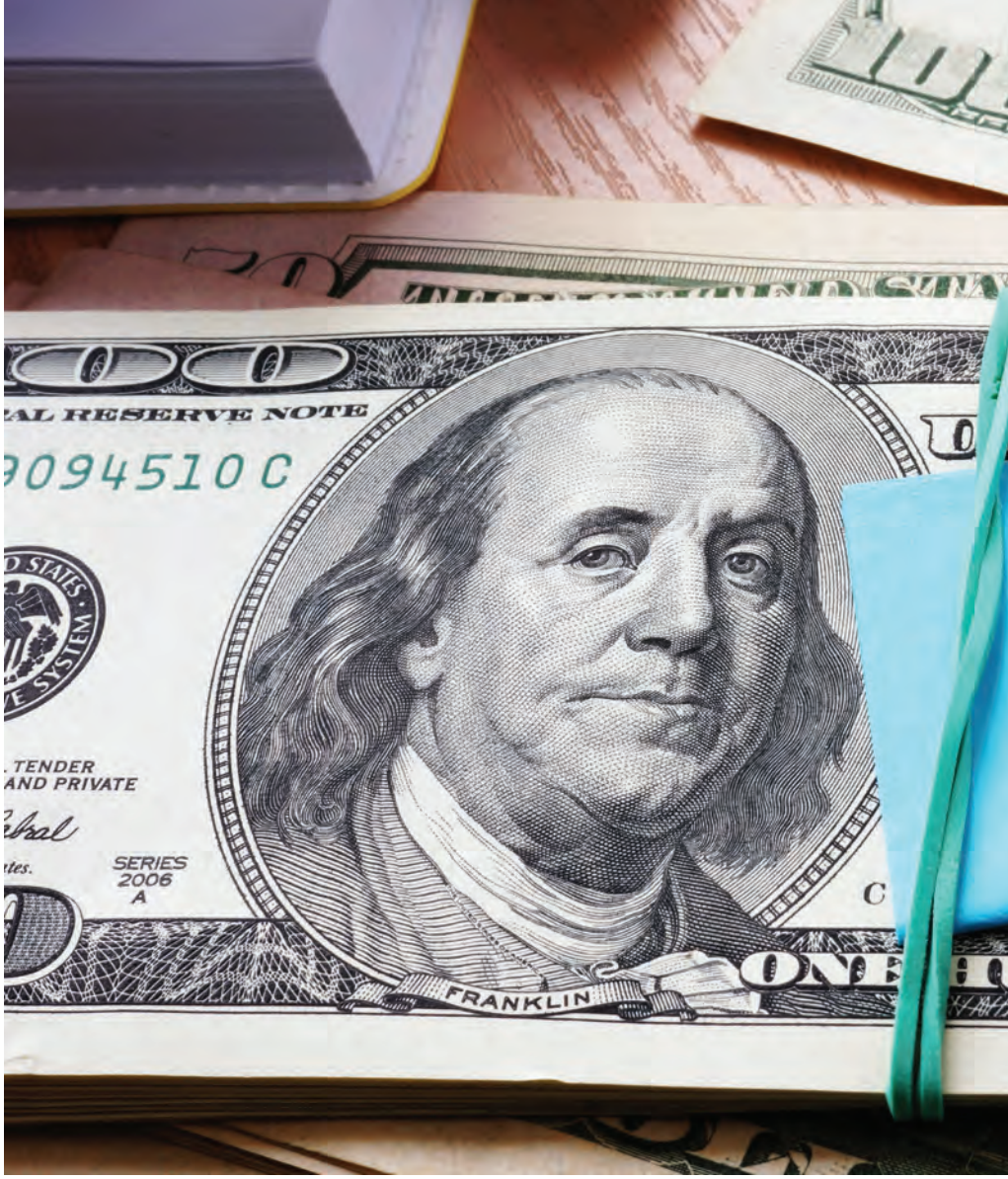

The Tax Deduction Was an Important Factor for Dispute Resolution

Whatever the reason, the loss of the alimony deduction creates a seismic change in matrimonial law. Pennsylvania Statute 23 Pa. C.S.A. §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. In addition, alimony is a factor in determining adjusted gross income for purposes of support under Pennsylvania Rule 1910.16-2. The Pennsylvania Superior Court in *Reisinger*, 471 A.2d 544 (1984), held that the alimony deduction and its impact on the payor's tax return should be a factor in determining the amount of alimony award. It would seem to follow that the loss of the deduction should have an impact on future alimony awards. Without the deduction, adjusted gross income will rise and the cost of alimony will increase.

As an example, under the old rules, if a payor in a 33 percent tax bracket paid $100 in alimony, the cost after a tax deduction was $66.70. If the recipient was in the 20 percent tax bracket, the payment of $100 would be reduced by a tax of $20 for a full benefit of $80. Under the new law, the payor of that $100 receives no deduction, so the cost of the same alimony rises to $133. The recipient gets the full $100. The effect is to shift the tax burden of alimony to the payor. Future private settlements will likely factor in this shift.

The application of one set of laws for some and another for others, depending upon the timing of a finalized agreement or decree, creates confusion and new opportunity for litigation.

How family court masters and hearing officers will deal with this shifting of tax burdens is something that the family bar needs to pay attention to. We do not know if the courts will reduce the amount paid as alimony to equalize the burden presented by the loss of the tax deduction or preserve the net benefit. The comment to Pennsylvania Rule §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." For some, the current formulas are presumptively controlling, while other triers of fact rely upon tax returns. We are told that revised formulas for support are underway and we can assume that the purveyors of support software are in the process of preparing updates.

Pressure to Conclude Settlements in 2018

The new law applies to instruments finalized after 2018. An "instrument" includes 1) a decree of divorce or separate maintenance or a written instrument incident to such a decree, 2) a written separation agreement or 3) a decree requiring a spouse to make payments for the support or maintenance of the other spouse. This is the same definition found in IRC Section 71(b)(2). A written agreement in any form is required, but an agreement is not defined in the code or regulations. Using prior case law as a guide, an agreement can be a series of letters or emails. Think offer and acceptance. The looming deadline for finalizing agreements will have a profound impact on

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current negotiations and court calendars. Consider the pressures or opportunities for mayhem that may come from one side refusing to negotiate or from last-minute appeals.

Casting further confusion into the mix is the simple addition to the law that says: "any divorce or separation instrument (as so defined) executed on or before such date and modified after such date if the modification expressly provides that the amendments made by this section apply to such modification." Because a "divorce or separation instrument" includes a court decree, the modification of a decree can compel a shift to the new taxing paradigm. One can only ponder under what circumstances a hearing officer, master or judge might consider changing an order for support and alimony determined under the old law to the new. And if the change is made, what tax calculations will be used to make that new determination? Modifications of older agreements arrived at privately will continue to apply the old law with respect to alimony unless they affirmatively state that the new law should apply. Our courts may be wishfully inclined to encourage parties in litigation to reach their own compromises.

The Personal Exemption is Now Zero

Under the new law, for tax years 2018 through 2025, the personal exemption is zero. The personal exemption was often a subject for negotiation in divorce settlements. 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." (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 noncustodial parent in a written declaration on IRS Form 8332. The

dependency exemption remains relevant in divorce negotiations as only the parent with the dependency exemption may claim the child tax credit, now $2,000 under the new law, or qualify for the new $500 deduction for dependents over 17. Because the personal exemption may return in 2026, agreements should address that eventuality now.

The Elimination of Some Difficult Issues

Some headaches are eliminated with the loss of the alimony deduction. Under the old law, there was a complicated calculation found at IRC§71(f) that prevented payors in a divorce from front-loading large payments and calling them alimony when in reality they were nondeductible property transfers. The recapture laws would result in the reversal of an alimony deduction. Without the deduction, recapture is no longer an issue.

Another headache gone is the calculation of phantom alimony — the equivalent of third-party payments made on behalf of the alimony recipient. The very definition of alimony included payments made directly to others for things like rent, mortgage, tax or maintenance on a home owned by the payee spouse. The result was the realization of income by the beneficiary of these payments without the actual cash to pay the tax. This, too, is an issue that is gone.

A third headache that is eliminated is the need to allocate a payment between deductible alimony and nondeductible child support. The allocation was often the subject of litigation, with the IRS weighing in to conduct a facts and circumstances analysis to apportion a single payment between deductible and nondeductible support. Now there is no tax difference between the payment of child support or alimony beginning with agreements finalized in 2019.

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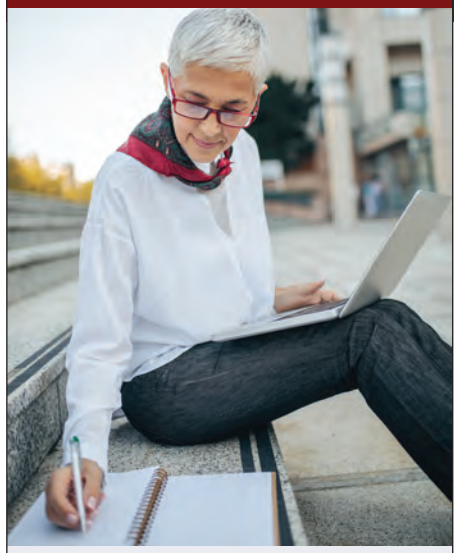

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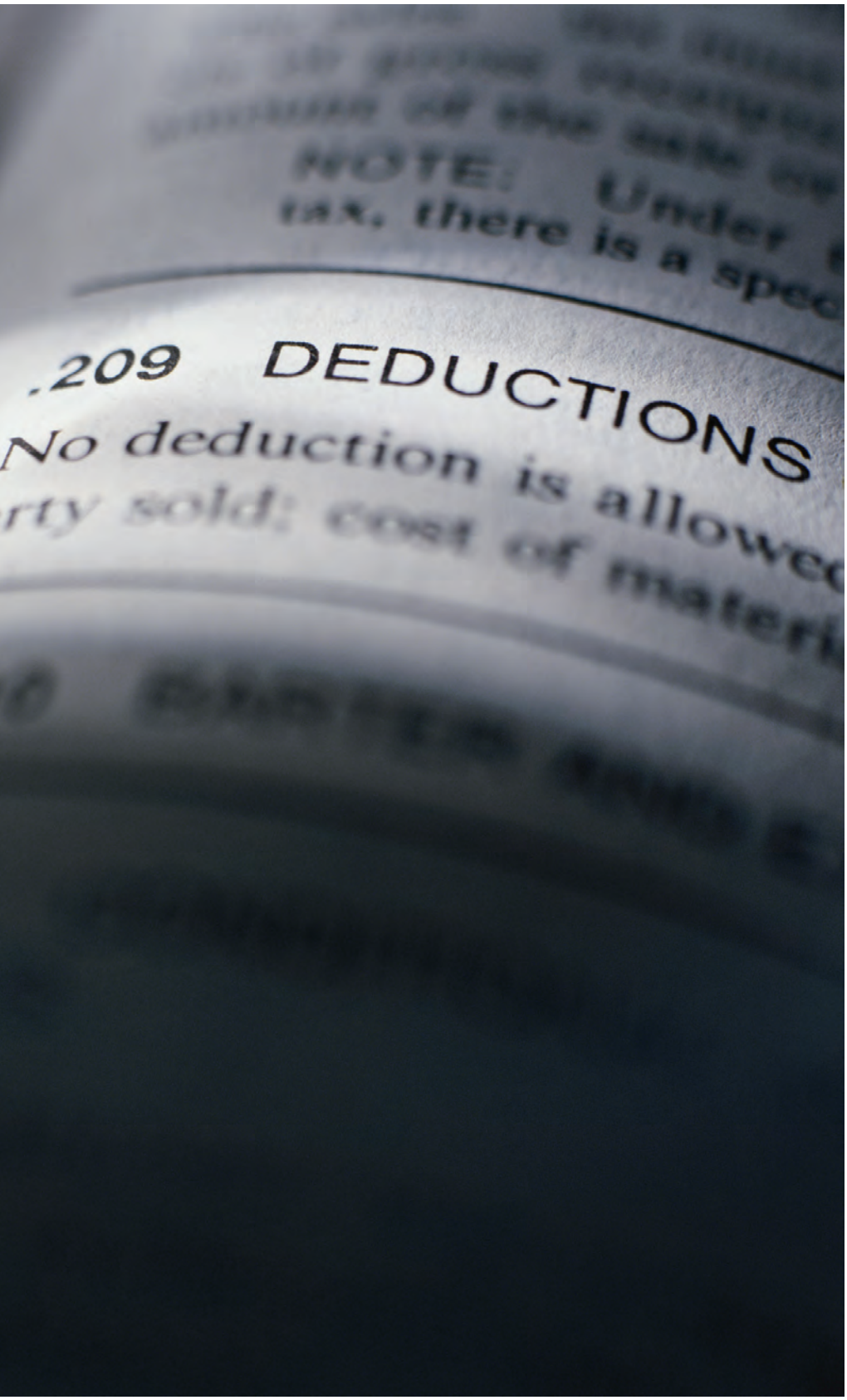

For recipients of alimony, there are two additional unforeseen outcomes. In prior years, the income reported from alimony could be used to qualify for an IRA contribution. Without reported alimony income, some dependent spouses with no other source of income will lose the opportunity to contribute to an IRA. Second, for lower-income taxpayers, the fact that alimony is no longer taxable income means that they can receive a large alimony award and still be eligible for the earned income tax credit. This may seem like a windfall that Congress may correct in the future.

Ultimately the IRS will still be receiving some returns showing an alimony deduction because those returns were finalized under the old law. It seems that only a tax audit will elicit proof that a taxpayer is entitled to a claimed deduction. Those claiming the deduction might be advised to attach a copy of their agreement or decree to their return.

Conclusion

What may have seemed like a rational idea at the outset has become a very complicated readjustment in the practice of matrimonial law. The calculations for alimony and support have been altered and are much more complicated to determine. The application of one set of laws for some and another for others, depending upon the timing of a finalized agreement or decree, creates confusion and new opportunity for litigation. How this resolves itself will be interesting to observe, although for those in the process of resolving a marital dispute this year, the outcomes are personal rather than academic. And while this new law has no sunset date, many of the new tax act provisions expire at the end of 2025. If that were to occur and we were to revert to the former law

regarding alimony, the resulting confusion and mayhem will far exceed those of the present. ⚖

Phyllis Horn Epstein is partner with the Philadelphia law firm of Epstein, Shapiro & Epstein PC, with more than 30 years' experience in taxation, corporate transactions, and trusts and estates. She represents clients before the IRS and the Pennsylvania Department of Revenue and in the U.S. Tax Court and the Orphans' Courts of Pennsylvania. She is a fellow of the American College of Tax Counsel and a recipient of a PBA Special Achievement Award for her three years of service as treasurer of the PBA.

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