TAX TRENDS AND DEVELOPMENTS

Highlights of 2017 Tax Reform Act's Effects on Divorce

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The 2017 Tax Reform Act was signed into law in December 2017. Some of its significant effects on divorcing couples are summarized below.

Alimony Deduction

New Law

Alimony, that is, spousal support, will not be deductible by the payer or taxable to the payee for divorce and separation judgments and decrees entered on or **after December 31, 2018**.

This also applies to **modified** judgments of divorce or separation effective after 2018.

And, it applies to divorce and separation decrees entered before December 31, 2018 if the parties elect to have the new law apply.

But, it does not apply to other divorce and separation decrees entered before December 31, 2018. Thus, for all existing divorce settlements and those entered by year-end, alimony will continue to be taxable/deductible.

Comments on the New Law

1. Window for Creative Use of Section 71 Payments— Because most alimony payers are typically in a considerably higher tax bracket than most payees, the tax saved by the payer usually exceeds the tax paid by the payee. This has set the stage for creative uses of "Section 71 payments" under which the disparity in tax brackets can be used to provide a tax subsidy.

Examples include using Section 71 payments to:

- Divide non-qualified deferred compensation on a taxable/deductible basis.
- Structure installment payments of a business buy-out of the non-owner spouse's marital interest on a taxable/deductible basis.
- Pay attorney fees on a taxable/deductible basis.

However, after 2018, these opportunities and similar others will no longer be available. So, in situations where there is significant disparity in brackets, consider whether using Section 71 payments would be beneficial.

2. Fundamental Change in the Dynamic of Alimony/Spousal Support—When the alimony deduction was enacted in 1948, the theory was that, if a former family's income is split between the parties in some manner post-divorce, the tax treatment should correspond.

As noted, the result in many cases has been less combined tax paid on the payer's income. Because of budgetary concerns - including the enormous cost of 2017 TRA - eliminating the alimony deduction became a revenue raising option to help alleviate the deficit increasing effect of the TRA.

This creates a new paradigm for divorce practitioners and alimony guideline providers, that is, thinking in terms of after-tax dollars for spousal support, similar to child support.

3. Effect of Post 2018 Judgment Amendments—If a pre-2019 divorce or separation judgment or decree is amended on or after December 31, 2018, the new nontaxable/nondeductible law applies.

Query: Would this be the result even if the amendment does not pertain to spousal support? If the answer has not become clear by year-end, the distinct possibility of losing taxable/deductible status of spousal support payments must be considered before advising the post-2018 amendment of a pre-2019 judgment providing for taxable/deductible alimony.

Personal And Dependency Exemptions

New Law

The federal personal and dependency exemption - $4,050 in 2017 for each taxpayer and each of his/her dependents – is repealed beginning in tax year 2018.

The $4,000 Michigan income tax personal and dependency exemption is based on the number of exemptions claimed on a taxpayer's federal return. Thus, it too would be lost incident to the federal repeal. But, at the time this article is written, there is reason to believe that Governor Snyder will push legislation to preserve the Michigan exemption.

Comments on the New Law

1. Michigan Exemptions—Since the Michigan income tax personal and dependency exemptions are likely to be preserved,

it still is advisable to specifically provide for who is entitled to the exemption for dependent children.

2. Need for a Michigan Form 8332?—As noted, the entitlement to Michigan exemptions has been tied directly to the number of exemptions claimed on a taxpayer's federal return and there is no Michigan income tax provision allowing the custodial parent to release an exemption to the non-custodial parent.

Thus, it seems that, accompanying new Michigan law to preserve the exemption for state tax purposes, should be a provision allowing the release of the exemption from one parent to the other.

Perhaps by a Michigan counterpart to federal Form 8332, the execution of which has allowed for such releases for federal tax purposes.

Standard Deduction

New Law

The standard deduction—used in lieu of itemizing deduction—was almost doubled under the 2017 TRA. For joint filers, it is $24,000 in 2018; single - $12,000; head of household - $18,000.

Comment on the New Law

Offset, More or Less, by Repeal of Exemptions—The benefit of the increased standard deduction is reduced, or eliminated, by the loss of personal and dependency exemptions.

Example:

For a family of 4 filing a joint return:	Under TRA	Pre TRA
Standard Deduction	$24,000	$13,000
Personal & Dependency Exemptions	0	16,200
Total Deduction	$24,000	$29,200

The decrease in the total deduction is offset in part by the TRA's lower tax rates (see below).

Miscellaneous Itemized Deductions

New Law

Currently, certain expenses are deductible as miscellaneous itemized deductions to the extent they exceed 2% of adjusted gross income (AGI). Such expenses include tax preparation fees, investment advisory fees, unreimbursed employee expenses.

They also include attorney and accounting fees incurred in divorce that are attributable to (1) efforts to obtain spousal support and (2) tax advice.

Under the TRA, effective January 1, 2018, deduction of all such fees and expenses is eliminated.

Comment on the New Law

The deduction of a portion of divorce related fees has made them less expensive for clients who itemized deductions.

However, except for higher asset cases, more clients will be using the higher standard versus itemizing deductions.

New Tax Rates

New Law

Tax rates have been, in the main, modestly reduced and are as follows effective January 1, 2018:

	Taxable Income		
Tax Rates	Single	Married Filing Jointly	Head of Household
10%	0-9,525	0-19,050	0-13,600
12%	9,526-38,700	19,501-77,400	13,601-51,800
22%	38,701-82,500	77,401-165,000	51,801-82,500
24%	82,501-157,500	165,001-315,000	82,501-157,500
32%	157,501-200,000	315,001-400,000	157,501-200,000
35%	200,001-500,000	400,001-600,000	200,001-500,000
37%	Over 500,000	Over 600,000	Over 500,000

Comments on New Law

1. Lower Rates —The 7 tax rates ranging from 10% to 37% are 2%-3% lower than previous rates. For instance, a married couple with $75,000 of taxable income will pay $8,619 versus $10,297.

2. Tempered by Loss of Certain Deductions—The lower rates are offset, to varying degrees for different taxpayers, by the elimination of personal and dependency exemptions and loss of some itemized deductions.

About the Author

__Joe Cunningham__ has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy, though his practice is statewide.

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