TAX TRENDS AND DEVELOPMENTS

Beware: Spousal Support Tax Treatment Changes January 1, 2019

By Joseph W. Cunningham, JD, CPA

As previously reported in this column, the 2017 Tax Cuts and Jobs Act (Act), signed into law in December 2017, radically changes the tax treatment of alimony/spousal support beginning in 2019. The other changes made by the Act affecting divorce took effect January 1, 2018.

Thus, there is a small window within which to decide whether to have existing law – or the new law - apply to divorces that can be finalized this year or next.

The New Law

In a total reversal, alimony/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.

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

The Act is Not Applicable to Divorce and Separation Decrees Entered Before December 31, 2018

For all existing divorce settlements and those entered by year-end, alimony will continue to be taxable/deductible.

Hence, a window of opportunity before year-end for the many situations in which the alimony payer is in a meaningfully higher tax bracket than 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. In situations where there is significant disparity in brackets, using Section 71 payments in such circumstances may no longer be beneficial.

Effect of Judgment Amendments Post 2018

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.

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.

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 the Act—eliminating the alimony deduction became a revenue raising option to help alleviate the Act's deficit-increasing effect.

This creates a new paradigm for divorce practitioners and alimony guideline providers. That is, we will need to think in terms of after-tax dollars for spousal support, similar to child support.

How to Avoid Paying Alimony with After-Tax Dollars Under the New Law?

One approach is to negate the adverse tax consequences of the new law by using 401(k) funds. As we know, more and more employees have 401(k) accounts than in years past.

Example

- H, 40 years old, is a middle-management employee at a small company. He earns $60,000 a year. He has a combined 26% federal-state income tax bracket.
- W is a stay-at-home mom who works part time and earns $10,000 annually. Hence, as head-of-household, her standard deduction offsets her income for federal taxable tax. Her income is subject to minimal Michigan tax.
- The parties agree on alimony of $1,250 a month, i.e., $15,000 annually, for 5 years when their youngest child will be either working or in community college.
- H has a 401(k) balance of $150,000, which is split evenly with W receiving $75,000 and H receiving $75,000.
- In addition to W receiving her $75,000 share, the parties agree that H will transfer his $75,000 share of the 401(k) to W in lieu of spousal support. She can withdraw $15,000 annually, paying approximately $2,000 in tax. H will pay W $2,000 per year to reimburse her for the taxes she will pay on her withdrawals. Thus, W will have $15,000 per year, which is $1,250 a month after-tax spousal support.
- While W ends up with $15,000 a year after tax either way, using the 401(k) account saves H tax as follows:

	Not Use 401(k)	Use 401(k)
Payments Over 5 Years:		
Payments	$ 75,000	$10,000
Tax at 26% to Provide Funds	$ 26,000	$ 3,500
401(k) Funds	0	75,000
Total Cost to H	$101,000	$88,500

Observations

1. The example shows that, in relatively modest circumstances, use of a 401(k) account can result in considerable tax savings.
2. It provides a means of using pre-tax dollars to fund after-tax obligations – an advantage where there is disparity in brackets.
3. In the example, the tax on H's $75,000 share of the 401(k) was shifted to W – at her lower bracket – incident to satisfying his after-tax spousal support obligation.
4. At 40, H has ample time for his 401(k) account to be replenished.
5. Using 401(k) funds for a spousal support obligation as shown in the example requires that the plan allow for annual withdrawals, Many plans do not do so. But, a small business plan, as in the example, often does.
6. A 401(k) account can be used for other purposes, such as buying out the other spouse's marital interest in (1) a business or (2) a cottage up north.

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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