TAX TRENDS AND DEVELOPMENTS

Use of QDRO Funds to Pay Spousal Support and Receive a "Disparity in Brackets" Tax Benefit

By Joseph W. Cunningham, JD, CPA

As is widely known, spousal support was previously taxable to the recipient and deductible by the payer. However, pursuant to the Tax Cuts and Jobs Act of 2017, alimony payments provided in divorce documents executed after January 1, 2019 are no longer taxable/deductible.

When they were taxable/deductible, the parties could take advantage of a disparity in tax brackets, hence "whipsawing" Uncle Sam, as follows:

- H is required to pay W spousal support of $5,000 a month - $60,000 a year - for 5 years.
- H is in a 40% combined federal & state tax bracket; W's combined bracket – 20%.
- On an annual basis, the payments and taxation thereof were as follows:

	Payment	Tax/ Tax Savings	Net of Tax
H	(60,000)	24,000	(36,000)
W	60,000	(12,000)	48,000

- So, because of the disparity in brackets, it cost H $36,000 to provide W $48,000. Uncle Sam pitched in the additional $12,000.
- Multiply this by five years and the "tax subsidy" was $60,000.

Though no longer available due to the change in the law, the tax benefit from a disparity in tax brackets can still be achieved by use of a QDRO for a defined contribution plan – such as a 401(k) plan.

For example, assume the same facts as above – including H's and W"s respective tax brackets.

- H & W sign a QDRO providing that his 401(k) plan pay W $60,000 a year.
- W will pay $12,000 tax on the $60,000, netting her $48,000.
- The payments are not subject to the 10% early withdrawal penalty regardless of W's age under IRC Section 72(t).
- H has used pre-tax funds to satisfy his spousal support obligation.
- He has effectively shifted the tax on $300,000 – on which he would ultimately be taxed at his 40% bracket - to W at her lower 20% bracket.

Observations

1. In situations where there are (1) a meaningful disparity in tax brackets; (2) a spousal support obligation; and, (3) the payer has a 401(k) savings plan, consider using a QDRO to shift the incidence of tax from the high bracket payer to the low bracket payee.
2. This cannot be done, however, by transferring the entire amount - $300,000 in the example - which the payee would roll into an IRA.

   Reason – once transferred to an IRA, withdrawals are subject to the 10% penalty tax if the withdrawing party is under age 59 and a half.

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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