THE END OF ALIMONY

BY: Phyllis Horn Epstein, Esquire ©
Epstein, Shapiro & Epstein, PC
1515 Market Street, 15th Floor, Philadelphia, PA 19102
Phyllis@eselaw.com

Presently, or at least until January 1, 2019, alimony can be taken as an income tax deduction by the payor of alimony under Internal Revenue Code (IRC)§215(a) and should be reported as income by the recipient under IRC§61(a)(8). In order to be deductible, payments have to be made in cash and as a result of 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. The terms of payment cannot provide for any substituted transfers in the event of non-payment.

Section 11051 of the Tax Cuts and Jobs Act of 2017 upends this long standing tax approach by removing the alimony tax deduction and at the same time no longer requiring alimony to be reported as income when received. Nothing happens in a vacuum and the result of this simple declaration has ripple effects for a large body of tax law in place. For example.

Rush To Sign by December 31, 2018.

The change in the law will not impact anyone with an agreement in place by the end of next year, December 31, 2018. This will undoubtedly have a profound impact upon negotiations with a rush to complete final agreements by year end 2018. In addition, the IRS will be faced with the mighty task of determining which tax returns should be reporting alimony under the old scheme - income to recipient and deduction for payor - or under the new scheme - no income reporting and no deduction. Under the new law the payment will be a non-event from a tax point of view so that only those agreements under the old law will be showing up on tax returns. But only a tax audit will elicit proof that a taxpayer is entitled to a claimed deduction with the taxpayer providing evidence of a qualified pre-2019 agreement. Perhaps new revised tax reporting on Form 1040 (the standard individual tax return) will compel attachment of such agreements for every return claiming the deduction. Could this be problematic for payment recipients? Possibly at least because the taxation symmetry requires them to report alimony as income and at least on Form 1040 to date the payor of alimony is required to supply the tax identification number of his or her spouse who receives income.

Is it Alimony or Property Division? Alimony Recapture no Longer Recalculated.

The IRS devised a set of rules to prevent front-loading of payments and calling them alimony when in reality they are non-deductible property transfers. The recapture laws

1 IRC§ 61(a)(8); IRC§71; IRC§62(a)(10)
found at IRC§71(f) would result in the reversal of an alimony deduction. Because there is no longer an alimony deduction, there is no longer an incentive to disguise property division as alimony. It would seem then that the entire set of alimony recapture laws are no longer operative for agreements entered into after December 31, 2018. The way the recapture law worked was through a computation that was done post-facto. The amount of the recapture which was realized in the third year after alimony had begun was calculated by taking the excess of alimony payments in the second year over the sum of payments in the third year plus $15,000, PLUS the excess of the payments in the first year over the sum of the average payments in the second year and third year plus $15,000. A complicated calculation that will not be necessary going forward and for some a welcome relief.

**Will we even need an agreement going forward?**

In order for alimony to be deductible, the payments (in addition to other things) had to be made pursuant to a written divorce or separation agreement or court order. IRC§71(b)(2)

There are many cases dealing with the question of whether something is or is not a written separation agreement. One such case Mudrich, TC Memo 2017-101 held that a husband’s promise to split his bonus with his ex-wife was not made pursuant to a satisfactory agreement and therefore denied him the alimony deduction. The agreement called for the separation of an item of property but never mentioned that the payment was for spousal support.

There have been other opportunities for drafting mishaps. The Code also requires payments to cease upon the death of payor in order to be considered alimony. There is disagreement between the IRS and the Tax Court regarding whether the amount of alimony must be a definite amount (the IRS view) or an ascertainable amount (the Tax Court view).

It seems that all of these issues requiring careful drafting are going to be a thing of the past.

**Phantom Alimony - Gone**

Payments to others on behalf of the recipient spouse may be alimony if required under a property settlement agreement. The result of this scenario is that the beneficiary of these payments had taxable income but no cash with which to pay the tax. How does it work? For example, payments that the payor spouse makes directly for rent, mortgage, tax or maintenance on a home owned by the payee spouse will qualify as deductible alimony. (The same does not hold true if the home is in the name of the payor spouse regardless of what is stated to in a property settlement agreement.) Half of what is paid for these home related expenses on a jointly owned home in which the payee spouse continues to reside may be deducted as alimony. In addition, life insurance premiums that a payor spouse was obligated to pay by reason of a property settlement agreement directly to a life insurance company were alimony so long as the policy was owned by the payee spouse.
Now, none of these payments are income and none are deductible by the paying spouse. Phantom income is gone.

**Tax Implications are Still a Factor for determining alimony under local law.**

Our 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. The current automated calculations reach an amount of alimony generally based upon relative incomes and expenses. 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.” The question is whether these programs correct for the tax implications of alimony and whether going forward, the loss of the alimony deduction changes that calculation. Very simply, the loss of the deduction increases the amount paid as well as the amount received. Some adjustment seems warranted.

Currently, spouses are at liberty to alter the tax consequences of alimony by agreement so that the payor no longer receives the deduction and the recipient no longer includes payments in income. An overall savings may be the motivation.

Illustration: Husband pays $20,000 a year for support. Husband is in the 28% tax bracket, and W is in the 15% tax bracket. If the payments are alimony then Husband saves $5,600 in taxes. Wife includes the entire amount as alimony and pays a tax of $3,000. The savings of $2,600 represented by the difference in tax reporting can be incorporated into the final divorce agreement.

These adjustments will no longer be available however the cost of support/alimony to the payor will vary from person to person depending on their own individual tax status. Will this be considered as part of the settlement process or the alimony calculation? We don’t know.

**Allocation headaches over?**

When support for children is required in addition to alimony or spousal support, it has been the best practice to clearly identify each payment since child support, unlike alimony, is neither deductible by the payor or included in the income of the recipient. In those cases where it was unclear how much of a payment was deductible alimony and how much was non-deductible child support litigation often ensued. When IRS was involved, the Service would conduct a facts and circumstances analysis to apportion a single payment between deductible and nondeductible support. For example, the Service might consider whether there was an agreement to reduce payments upon the occurrence of certain events like a child’s graduation from High School. The reduction would imply an amount designated as nondeductible child support.
If the taxpayer owed a combination of child support and alimony and during the year paid less than obligated, then the payments were first allocated to child support regardless of whether the parties agree otherwise. 2 By way of illustration:

Husband is obligated to pay to Wife $20,000 for alimony and $12,000 for child support and pays only $8,000 for the year, then the entire amount is treated as non-deductible child support and none of the payments are allocated to alimony.

None of this tax planning is required now that alimony is no longer deductible or income. There is no tax difference between the payment of child support or alimony. At least that will be the law for agreements entered into starting in 2019.

Personal Exemptions Eliminated

Under the law as we knew it before 2017 tax reform, taxpayers adjusted their gross income by taking personal exemptions for themselves, their spouse and dependents. For 2018 that exemption was going to be $4,150 for each person subject to a phase out based upon income. Under the new law, for tax years 2018 through 2025, the personal exemption is zero.  

The personal exemption was a subject for negotiation in divorce settlements. 4 A husband and wife could not both claim an income tax exemption for the same child. Presently, 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.” IRC §152(e)(4)(A) (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 non-custodial parent in a written declaration that is 1) signed by the custodial parent; 2) must state the years to

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2 IRC § 71 (c)(3); Haubrich, TC Memo 2008-299
3 IRC§151(d), as modified by Act Sec. 11041(a)
4 IRC §151(d), as modified by Act Sec. 11041(a) 152(e) Special rule for divorced parents, etc. (1) In general. Notwithstanding subsection (c)(1)(B), (c)(4), or (d)(1)(C), if – (A) a child receives over one-half of the child’s support during the calendar year from the child’s parents – (i) who are divorced or legally separated under a decree of divorce or separate maintenance, (ii) who are separated under a written separation agreement, or (iii) who live apart at all times during the last 6 months of the calendar year, and – (B) such child is in the custody of 1 or both of the child’s parents for more than one-half of the calendar year, such child shall be treated as being the qualifying child or qualifying relative of the noncustodial parent for a calendar year if the requirements described in paragraph (2) or (3) are met.

(2) Exception where custodial parent releases claim to exemption for the year. For purposes of paragraph (a), the requirements described in this paragraph are met with respect to any calendar year if – (A) the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year, and (B) the noncustodial parent attaches such written declaration to the noncustodial parent’s return for the taxable year beginning during such calendar year.

5 IRC §152(e)(4)(A)
which it applies; 3) must name the non-custodial parent who is the recipient of the exemption; and 4) must be unconditional. In order to claim the exemption, the noncustodial parent must file with his or her tax return this written declaration on IRS Form 8332 or a similar statement containing all of the same information. A court order is insufficient if it does not have the signature of the custodial parent attached. The Tax Court has held that the Form must actually be attached to the return and cannot be submitted at a later date. The release of the dependency exemption can be revoked under a similar process using Form 8332.

A “qualifying child” dependent as defined under Section 201 of the Working Families Tax Relief Act of 2004 (1) must be the taxpayer's child (including adopted or foster child), stepchild, sibling, or stepsibling or a descendent of such a relative; (2) has the same principal place of abode as the taxpayer for more than one-half of that tax year; (3) must be under age 19 at the close of the calendar year, under age 24 if a full-time student, or of any age if permanently and totally disabled; (4) hasn't provided over one-half of his own support for the calendar year in which the taxpayer's tax year begins; and (5) hasn't filed a joint return (other than for a refund claim) with the individual's spouse for the tax year beginning in the calendar year in which the taxpayer's tax year begins. For purposes of the Child Tax Credit a qualifying child is under age 17.

Will it matter who has the dependency exemption in the future?

While the dependent status of a child is not significant for purposes of claiming the personal exemption on a tax return, there are other tax reasons for claiming a child as a dependent. First, while the personal exemption is temporarily zero, it may someday - after 2025 - return. Further, there is still a $500 deduction for dependents over 17 or older. And importantly, only the parent with the dependency exemption may claim the child tax credit now $2,000 under the new law.

Even when there is a release and transfer of the dependency exemption both parents may claim the child as a dependent for purposes of excluding medical reimbursements, excluding employer-provided accident or health plan coverage, deducting medical expenses, the exclusion of health savings account distributions for qualified medical expenses and the exclusion of Archer medical savings account distributions to pay qualified medical expenses - to the extent these deductions and credits survive the 2017 reform act. So for example, in 2017 and 2018 medical expenses can still be itemized but only to the extent they exceed a floor equal to 7.5% of adjusted gross income. Most other deductions are “suspended” by the new law. Starting in 2019, medical expenses will be subject to the 10% floor for both regular tax and AMT purposes.

So, a custodial parent, even without the dependency exemption can still claim the child and dependent care credit, the exclusion for dependent care benefits, the health coverage tax credit, the earned income tax credit and head of household status. Only the parent with the dependency exemption can claim the child tax credit. For this alone it matters which parent has the dependency exemption.

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6 See Section 11022 modifying IRC 24(h)(4)(A) & (h)(4)(C)