The Lost Alimony Deduction Starting in 2019

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The History.

Alimony payments have been a tax deduction for nearly 75 years. That ended with the new Tax Cuts and Jobs Act of 2017. Effective January 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). TCJA Section 11051 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.

The only indication of the thought process that went into this radical change appears in the House Bill comments that say they wish to return to the law of Gould v. Gould, 245 U.S. 151 (1917) that held that alimony - in that case - was not income. The Gould case was not decided on constitutional grounds but was rather an interpretation of the Tax Act of 1913 in effect at the time. That law was silent on whether alimony was income.

Subsequently our tax laws were changed to add sections 71(a) and 215 (and their predecessor sections) which were created for the purpose of uniformity among the states. The Constitutionality of those sections was first upheld by the Court of Claims in Mahana v. U.S. (1950). Alimony was taxable because it represented “income to spend, live on, to save.” Later, the ninth circuit court of appeals affirmed the Tax Court in Fairbanks v. Cmr. 191 F.2d 680 (9th Cir 1951) cert denied, 343 U.S. 915 (1952) holding that “the tax upon the income shall fall upon the ultimate recipient….The burden is passed with the money to her.” With “her” meaning the recipient of alimony.

Alimony tax gap.

According to the March 2014 report from TIGTA 47% of returns filed in 2011 with an alimony deduction did not have a corresponding return showing alimony income. Of 567,887 returns, 266,190 claimed an alimony deduction of $10 billion without another return showing alimony income. There was a discrepancy of 2.3 billion in deductions claimed. The alimony tax gap could be symptomatic of cheating by those deducting alimony or an underreporting of alimony income by recipients. We don’t know. According to the House Bill comments the alimony tax gap was not the rationale for changing the law.
Shifting the tax burden.

Alimony for divorces occurring prior to 2019 is an above the line deduction which reduces adjusted gross income. It is not a miscellaneous deduction on Schedule A but appears (or appeared) on the front page of the old Form 1040 tax return.

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. 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% tax bracket paid $100 in alimony, the cost, after a tax deduction was $66.70. If the recipient was in the 20% tax bracket, the payment of $100 would be reduced by tax of $20 for a full benefit of $80.00. Under the new law, the payor of that $100 receives no deduction so the cost of the same alimony rises to $150. 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.

How future family court judges, masters, and hearing officers deal with this shift is something that the family law 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.

Pressure to Conclude Settlements in 2018 - It’s too late now.

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 as old 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.
**Modified Agreements.**

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.

**What ifs?**

There are some unanswered questions about how this law will be implemented. For example:
- If there is a Pre-nup agreement entered into before January 1, 2019, is this a written separation agreement or one that is incident to a divorce decree? Should parties amend and set out which law applies?
- If the agreement is before 2019 and the divorce is post 2018 which tax law applies? It seems that the old law will apply given that the definition of an “agreement” includes any “written separation agreement”

**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 non-custodial 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.

Keep in mind that only one parent can use a child as a qualifying child to take advantage of the dependency exemption, the Child tax credit, the Head of household filing status, and earned income tax credit (section 32). Both parents can claim a child as a dependent for purposes of medical expense deduction regardless of dependency exemption provided a child resides with one or more parents for over ½ year and receives more than ½ of the support.
The Elimination of Alimony Eliminates Some Difficult Issues.

Some headaches are eliminated with the loss of the 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 non-deductible 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 non-deductible child support. The allocation was often the subject of litigation with IRS weighing in to conduct a facts and circumstances analysis to apportion a single payment between deductible and non-deductible support. Now there is no tax difference between the payment of child support or alimony - starting for agreements finalized in 2019.

Ultimately the IRS will still be receiving some returns showing an alimony deduction because they were finalized under the old law. It seems that the 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 with their return.

The Loss of Alimony Income Creates Other Issues

Previously, alimony income could be considered “earned income” for purposes of making an IRA contribution. See IRC Section 219(f)(1) The new Tax Act deleted the language that said: “The term “compensation” shall include any amount includible in the individual's gross income under section 71 with respect to a divorce or separation instrument described in subparagraph (A) of section 71(b)(2).” So as a result, alimony recipients can no longer rely upon this source of income when determining their eligibility to invest in an IRA.

Another issue that mirrors the phantom income tax problem is the bedrock tax paradigm of Old Colony Trust. Recall that the U.S. Supreme Court laid down this old principle that we have since been living by: “The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.” Old Colony Trust Co. v. Cmmr. of Internal Revenue, 49 S. Ct. 499 (1929) Therefore, those payments by one ex-spouse to relieve the debts of the other may still be income - just not alimony income.
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 are 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 of course 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 provisions of the new tax act expire at the end of 2025. If that were to occur and we were to revert to the current law regarding alimony, the confusion and mayhem will far exceed the present.

The statutes have been fine tuned to create uniformity and clarity and ease of administration. Doing away with this tax scheme without a clear articulation of tax policy appears arbitrary and disruptive.

Some say that the goal of tax simplification is achieved by getting rid of the alimony deduction. Yet, the new law undermines simplification and is contrary to the principles espoused in Mahana and Fairbanks. First, some taxpayers will follow the old law - deduction for alimony payors, income for recipients. Others will follow the new law. It will be for IRS and the Tax Court (as well as the Family Courts) to determine which taxpayers fit under which law. This is a new fact question that will burden our courts and the Service. We will have two parallel systems of taxation in place for the same transaction that will continue on until the agreements or the parties expire.