US TAX REFORM - SPOTLIGHT ON DIVORCE AND SEPARATION ONE YEAR ON

In February 2018 shortly after the Tax Cuts and Jobs Act was passed, we wrote about a major policy shift regarding the US federal tax rules affecting spousal maintenance payments agreed in a financial settlement on divorce or formal separation. The changes came into effect on January 1st this year. Importantly, not every State of the US has incorporated the changes into their law and so those with any State tax filings need to review how the changes may affect their State tax position.

As a quick recap, under previous tax law, in general any payment in cash resulting from a divorce decree or formal separation agreement is considered alimony unless it falls outside the definition of alimony (which would warrant an article in its own right). Child support is not considered as alimony and is a non-tax item.

Alimony paid was deductible by the payor on his/her tax return and alimony received was picked up as income on the tax return of the recipient. This default treatment could be overridden by agreement and potentially by a provision in a tax treaty.

The new rules removed these provisions from the Internal Revenue Code and the changes are permanent, unlike many other changes made in the tax reform which have a ten-year sunset clause attached to them, where, absent any Congressional action, the tax law in effect prior to November 2017 will come back into effect by 2025. For any financial settlements signed now, payments of support will be treated as arising from after tax income and there will therefore be no inclusion in income for payments received, nor will there be a deduction allowed for the person making the payments.

All agreements ratified before the end of 2018 will still fall under the prior rules even for payments made after the end of 2018. It should be noted that if a settlement is revised for any reason after January 1st 2019, it does not automatically make the new alimony rules apply. However, a couple can elect to have the new rules apply if they so choose.

ALL AGREEMENTS RATIFIED BEFORE THE END OF 2018 WILL STILL FALL UNDER THE PRIOR RULES.

We have gradually been able to digest the impact of the rule changes as well as many other provisions that were included in the tax reform that used to form part of all financial settlement agreements, but are potentially irrelevant after the tax reform changes.

Traditionally, alimony settlements were set at a certain level because there was a tax benefit available to both parties, especially when the recipient spouse had little or no income of their own. Family lawyers and accountants were particularly busy in December trying to work through the financial implications of the changes and deciding whether it would be beneficial to push a settlement through before the end of the year or delay it until the new year.

In terms of other considerations arising from the new laws, it used to be possible to take tax deductions for dependent children, but the new tax law has removed that. Couples could write in to their financial settlements who would take the tax deduction. The loss of this deduction has also caused discussion around the relative financial impact of that and in some cases led to considerations of revising previous settlements made. It should also be noted that the provision in respect of the loss of the deduction for dependent children is one of those temporary changes mentioned earlier. Therefore, many Family lawyers are keeping the wording of agreements they draw up under the new rules as flexible as possible to account for some of these tax changes that sunset in future.

ACCESS TO THE 529 PLAN HAS BEEN EXTENDED TO COVER HIGH SCHOOL EDUCATION.

Under previous rules, alimony is considered to be 'compensation' for purposes of determining eligibility to make contributions to a qualified retirement plan. Now that the inclusion in income of alimony is removed, the recipient spouse will no longer be able to fund a pension of their own if this is their only source of 'compensation'.

In a separate change, access to the special US college savings plans known as 529 plans has been extended to cover high school education (up to $10,000) and this change is a permanent change not subject to the sunset provisions. This could potentially affect divorce agreements that were reached on the basis of how such funds in a 529 plan would be used. The party who created the account can now access a significant portion of the funds at an earlier stage. This will potentially affect their ability to meet the terms of an earlier agreement if certain assumptions were made in a financial settlement about the funding of college age education, which would have included some assumptions about the tax-free growth in the 529 plan.

Below is a very quick summary of some of the other major changes in the tax reform that could change the financial after-tax position of a divorced couple and in some cases lead to a desire to amend previous agreements reached. Most of these changes are however temporary and subject to the sunset provisions, and guidance is still being provided by the Internal Revenue Service on how some of the more detailed changes will be administered.

- General reduction in tax rates by increasing tax bands and reducing top tax rate to 37% from 39.6%
- Approximate doubling of the standard deduction amount ($12,000 for single or married filing separate, $24,000 for couples filing jointly)
- Income belonging to children subject to separate tax calculation instead of taxed at parent's tax rate
- Deduction for State income taxes and property taxes capped at $10,000 (previously unlimited although phased out for higher income earners)

- Deduction for interest payable on new mortgaged debt restricted (maximum $750,000 threshold)
- Interest on home equity loans no longer deductible unless used to materially improve property (previously interest on loan up to $100,000 for whatever reason was deductible)
- No deduction for miscellaneous items such as fees paid to professional tax preparer, fees paid to brokers for account management, certain job-related expenses. Unclear if fees paid to have Qualified Domestic Relations Order (QDRO) to share a pension in divorce remain deductible
- Increase in gross income limit for deducting cash contributions to charity (Now 60% up from 50%)
- Increase in child tax credit amount and income threshold above which entitlement stops
- Previously deferred earnings in a foreign corporation now included as income with resulting tax payable over eight years
- New rules expanding existing provisions that will result in income from foreign owned businesses being recognized even if no distributions are made
- Reduction in rate of corporation tax to 21% from 35%
- Allowance of a special 20% deduction for certain income from qualifying flow through entities e.g. partnerships

REDUCTION IN RATE OF CORPORATION TAX TO 21% FROM 35%.

At Frank Hirth, we did some numerical models to assist clients with the important decisions around alimony where a financial settlement could be concluded before December 31st 2018 or delayed to 2019. Below is a relatively simple example of the impact of the changes as they have evolved from old law in 2017 to new law in 2018 and then post alimony changes in 2019.

George and Mildred were divorced in 2016. Their financial settlement recorded spousal support at $60,000 per year payable by George to Mildred. George and Mildred have two children under age 18 who are now living with Mildred. George and Mildred claim the standard deduction. If they lived in a State which imposes a relatively high-income tax rate such as California and they had a mortgage, they would have a much higher deduction in 2017, but much curtailed in 2018 and 2019.

They would normally file as single individuals from 2017 onwards or possibly one of them might qualify for head of household status, but we use the single tax rates for this illustration. Mildred allows George to claim the children as dependents on his tax return in 2017. We also then show how the situation changes if their divorce happens in 2019 but we use the same amount of alimony as for 2017 and 2018.

	2017		2018		2019	
	George	Mildred	George	Mildred	George	Mildred
Wages and other income	200,000	50,000	200,000	50,000	200,000	50,000
Alimony (tax effect)	(60,000)	60,000	(60,000)	60,000	-	-
Gross income	140,000	110,000	140,000	110,000	200,000	50,000
Standard deduction	(6,350)	(6,350)	(12,000)	(12,000)	(12,200)	(12,200)
Dependent exemptions	(12,150)	(4,050)	-	-	-	-
Taxable income	121,500	99,600	128,00	98,000	187,800	37,800
Tax	27,002	20,863	25,001	17,816	41,412	4,342
Cashflow after tax and alimony	112,998	89,137	114,999	92,184	98,588	105,658

Combined net	202,135	207,183	204,426
Effect on George		+2,001	-16,411
Effect on Mildred		+3,047	+13,474

As can be seen, between the couple, the net cashflow as a unit is not that much different, year on year but the difference to each party individually is quite dramatic. This difference would be even greater if we incorporated a State tax deduction and mortgage or other deductions which have been eliminated or significantly reduced. In reality, if this couple were living in the US, there would also be State and possibly local taxes to pay. As mentioned earlier, not every State has conformed to the changes to the federal tax code. For example, New York still allows a deduction for alimony and also requires the recipient to continue to include it in their income. Practically that would mean very little change year on year to the New York taxes the couple pay.

The conclusion is that there is a material impact on the bottom-line after-tax cash in each party's pocket and discussions around alimony that take place now will certainly require new thinking and discarding old rules of thumb that were generally accepted as the formula to set alimony at the appropriate level.

DISCUSSIONS AROUND ALIMONY THAT TAKE PLACE NOW WILL REQUIRE DISCARDING OLD RULES OF THUMB.

For more information about Frank Hirth's services:

David Foster
David.Foster@frankhirth.com