How the Tax Cuts and Jobs Act Affects Divorce Settlements

The Tax Cuts and Jobs Act of 2017, signed by President Trump on December 22, 2017, made a number of important changes to the Internal Revenue Code, some of which either directly or indirectly relate to divorce. Due to the speed with which the law was enacted, there are many uncertainties in the interpretation and application of the changes. However, family law attorneys and other advisors must be proactive in ensuring they understand how these changes may affect their clients, particularly as they concern alimony, exemptions and deductions that could impact their clients' bottom line.

New Tax Rules for Alimony Agreements

The 2017 tax legislation introduced two significant changes to how alimony is treated for tax purposes, but stipulated that these changes would only apply to divorce or separation instruments that are executed after December 31, 2018.[1] For instruments executed after that date, alimony is no longer tax deductible for the paying spouse and does not need to be reported as income by the receiving spouse.[2,3] Unlike some other provisions of the new law, these rules are not set to expire and will remain in place unless changed by Congress in the future.

Agreements Executed on or Before December 31, 2018

Divorce or separation agreements executed on or before December 31, 2018 will be grandfathered in, provided the parties involved have a written separation agreement by that date. This means that as long as an agreement is reached prior to the deadline, paying spouses may still take the alimony deduction and receiving spouses must still report the alimony they receive as income. A decree of divorce need not be acquired by the deadline — a written separation agreement is sufficient under the law.

While existing alimony agreements can be amended to fall under the provisions of the new law should the parties involved desire it, it's unclear whether other modifications made after the December 31, 2018 deadline will cause the agreement to lose its grandfathered status. It's possible that modifying the agreement after the deadline might result in the paying spouse being unable to take the alimony deduction going forward.

Until the IRS provides guidance on this matter, it may be necessary to seek a private letter ruling (PLR) to clarify what the result of such modifications might be. This could be expensive. In addition to needing to hire an attorney to draft the paperwork needed to seek a PLR, a taxpayer will need to pay a "user fee" to the IRS.

1 As defined by Section 71(b)(2) prior to its repeal.

2 Repealing Section 215.

3 Repealing Sections 61(8) and 71.

Alimony Trusts

The new legislation repeals the section of the Internal Revenue Code that dealt with the taxation of alimony trusts.[4] Previously, the income of a trust payable to a divorced spouse would be taxable income for the beneficiary spouse, rather than the grantor spouse. Under the new law, this is no longer the case. The grantor spouse may have to pay the income tax on trust income, even though they do not receive the distributions from the trust.

It does not appear that existing alimony trusts will be grandfathered in and allowed to follow the old tax rules — grantors may have to follow the new law going forward.

Despite this change in the tax treatment of trusts, there may still be benefits to creating trusts in divorce, particularly if you wish to leave assets directly to heirs or need to provide support for an ex-spouse with whom you prefer to have no direct contact.

Changes to Exemptions and Deductions

The 2017 tax legislation also repealed several important exemptions and deductions that could affect divorce agreements.

Personal Exemptions and the Child Tax Credit

Personal exemptions have been suspended for the tax years beginning after December 31, 2017 and ending December 31, 2025. This means that during this eight-year period, divorcing parents will not be able to utilize the personal exemption for dependent children and do not need to negotiate which parent will be eligible to take it.

In the meantime, divorcing parents can negotiate which parent should be allowed to claim the Child Tax Credit. However, it's important to remember that when personal exemptions return in 2026, the Child Tax Credit must go to the parent who claims the personal exemption for the child.

Miscellaneous Itemized Deductions

Miscellaneous itemized deductions that could only be claimed if they exceeded 2% of the taxpayer's adjusted gross income have been suspended. Taxpayers will be unable to claim these deductions at all in the tax years beginning after December 31, 2017 and ending December 31, 2025. For divorcing couples, this means that fees incurred for tax advice related to a divorce are no longer deductible. Additionally, fees that a divorced spouse pays to an investment management firm to manage assets are no longer deductible.

Important Considerations Under the New Law

While we'd like the law to be black and white, there are still uncertainties in how the new tax law will affect divorcing couples. These uncertainties will have to be clarified by the IRS or the courts. In more complicated divorce cases, a family law practitioner would be wise to seek the counsel of a tax attorney or CPA experienced in this area. For now, divorcing couples should take a close look at their divorce or separation agreements and consider the following:

Review Withholding and Estimated Tax Payments

Any change in the tax treatment of alimony payments as a result of the 2017 tax legislation should also trigger a review of withholding and estimated tax payment requirements — whether you're entering into a new agreement or modifying an existing one.

Consult State Law

When the federal tax law changes, states may or may not adopt the federal changes for state law purposes. Each state is different. Couples need to look at their state tax law to determine whether the changes made by the 2017 legislation will also change the state income tax consequences of alimony.

Review Trusts

All trusts should be reviewed to determine how and to whom the income of the trust is taxed. To avoid potentially adverse tax consequences related to changes to the tax treatment of alimony trusts, taxpayers should consult with an experienced trust attorney to see if the trust can be modified. It may be possible to obtain a judicial modification or non-judicial settlement, or to decant (i.e., to transfer assets from the existing trust) into a new trust with more favorable provisions.

Review IRA Contribution Eligibility

The 2017 tax legislation repeals a part of the Internal Revenue Code that classified deductible alimony as "compensation" income for the purposes of determining eligibility for deductible IRA contributions.[5] This may result in an alimony-receiving spouse being ineligible to make an IRA contribution if the alimony was their only form of income.

Watch Out for Increases in Business Valuations

As a result of the increased cash flow due to the lower C corporation tax rate (reduced from 35 to 21%) and the qualified business income deduction (up to 20%) for pass-through entities such as partnerships, S corporations or sole proprietorships, divorcing couples must be aware of what could be a substantial increase in business valuations when preparing their settlement.

4 Section 682.

5 The third sentence of Section 219(f)(1).

A Game Changing Piece of Legislation

With a one-year delay in the effective date of the divorce-related provisions, divorcing couples and family law practitioners now have some lead time to finalize divorce and separation agreements and utilize the tax advantages available under the existing law. While there are sure to be further clarifications on how exactly the new law will be implemented, it is sure to be a game changer for how divorce and separation agreements are structured in the future. Partnering with trusted legal, tax, trust and estate, and wealth management advisors is critical to ensuring your understanding all of the implications of this new legislation.

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