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Tax & Estate Planning For Your Retirement Savings

WHAT'S INSIDE?

How the Tax Cuts and Jobs Act Impacts Alimony Payments

The sweeping changes created by the Tax Cuts and Jobs Act (TCJA) also extend to family law – *i.e., the treatment of alimony payments.*

For Better or for Worse?

Before TCJA, alimony was considered taxable income to the recipient and tax deductible to the payor. For the payor, this was an above-the-line deduction, meaning you can take the deduction without itemizing.

Beginning in 2019, this will change. Alimony will no longer be deductible by the payor and will be tax-free income to the recipient. This turnaround from the current treatment of alimony reverses law that has been in place since 1942.

Under TCJA, this new treatment will apply to payments required under a divorce decree that is either executed after December 31, 2018 *or* modified after that date, and the modification specifically opts into the new TCJA treatment of alimony payments. (This means that existing agreements and those executed by year's end will continue to use the pre-TCJA tax treatment for alimony.)

While the new TCJA rules might seem like a significant victory for spouses who receive alimony, *it is not*. First, the ability to take an above-the-line deduction of 100% of alimony payments provided an incentive to reach an agreement, as opposed to battling it out in court. Second, even though the recipient ex-spouse had to include the alimony as taxable income, many times this person had low enough income that the effect was negligible. Third, by taxing the paying spouse, the amount of tax ultimately paid is increased. That means there is less to split between the parties.

Example: After Jacob and Lisa divorce, Jacob will be in the 35% tax bracket and Lisa will be in the new 22% tax bracket. If their divorce agreement is executed...

- Before the end of 2018, every $1,000 of income received by Jacob that he uses to pay alimony will provide Lisa with $780 of after-tax income, after she pays her 22% tax rate on the sum [i.e., $1,000 – ($1,000 x 22%) = $780].
- After 2018, each $1,000 of income Jacob receives will be subject to $350 of tax (i.e., $1,000 x 35%). In other words, *IRS is collecting $130 more in tax* from the $1,000 used to pay alimony under the new rules.

After 2018, in order for Lisa to receive the same $780 of after-tax alimony that she would have had under the pre-2019 rules, Jacob would have to use 20% more of his pre-tax income, or $1,200 (i.e., $1,200 – 35% tax = $780).