

On December 20, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017 ("Tax Act"), ushering in an extensive array of new tax laws. Among them were some fundamental changes to the characterization and treatment of alimony.

General Rule and Effective Dates

Until January 1, 2019. Currently, and until January 1, 2019, the Internal Revenue Code (IRC) §215(a) allows a spouse who pays alimony ("Payor Spouse") to take a deduction on his or her income taxes for the amount of alimony he or she actually pays. Additionally, the spouse who receives alimony ("Payee Spouse") must report as income on his or her tax return the amount of alimony he or she actually receives. To be deductible as an alimony payment: (1) the payment must be made in cash; (2) the payment must be made pursuant to a divorce decree or separation agreement (it cannot be voluntary); (3) the payments must terminate no later than the death of the Payee Spouse; (4) the payment cannot be designated as a property settlement or child support payment; and (5) the spouses cannot be members of the same household when the payment is made.

After December 31, 2018. Under the Tax Act, the alimony deduction is eliminated if it is paid pursuant to a divorce decree or settlement agreement entered into after December 31, 2018. For divorces after this date, the Payor Spouse is no longer entitled to a deduction and the Payee Spouse is not required to claim the payment as income. It is important to note that for divorces prior to this date, the new law has no impact, and alimony is still deductible by the Payor Spouse and included as income by the Payee Spouse. However, both parties may modify the agreement to take advantage of the new rules if they both, for some reason, desire to do so.

How Does the IRS Know When You Were Divorced? Because those who were divorced prior to 2019 will still be entitled to a deduction for alimony paid, while those who were divorced after 2018 will not, the IRS will have the daunting task of determining which tax returns should receive a deduction for alimony and which should not. We expect guidance in the future as to how the IRS will resolve this (such as revising the Form 1040 to require a spouse to include a copy of the divorce decree if he/she is claiming a deduction for alimony paid).

Alimony Recapture No Longer an Issue for Divorces after December 31, 2018

Until January 1, 2019. Until January 1, 2019, the Payor Spouse could receive a deduction for alimony paid but not for property settlements. Therefore, many Payor Spouses tried to characterize property settlements as alimony. To prohibit this, the IRS imposed alimony recapture rules, set forth in IRC §71(f). These rules provide a formula that is applied to alimony payments. When an alimony payment is front-loaded to the point that it fails the formula, the payment is recharacterized as a non-deductible property settlement payment rather than a deductible alimony payment. When this happens, the Payor Spouse must go back and remove the deduction (i.e., recapture the income) on his or her income tax return.

After December 31, 2018. For divorces after December 31, 2018, the Payor Spouse no longer receives a deduction for alimony and is therefore no longer incentivized to disguise a property settlement as alimony. The recapture rules will no longer be needed.

Phantom Income (aka Phantom Alimony) Eliminated after December 31, 2018

Prior to January 1, 2019. Prior to January 1, 2019, if a Payor Spouse makes a payment to a third party on behalf of the Payee Spouse pursuant to a property settlement agreement, these payments are deemed alimony. For example, if Joe pays the mortgage, property tax, and maintenance on a home owned by Sue, his ex-wife, in accordance with their property settlement agreement, the payments are deemed alimony. Additionally, if Joe is required to pay insurance premiums on a life insurance policy owned by Sue, those premium payments are deemed alimony. Joe would receive a deduction for these amounts and Sue would need to report them as income. We call this Phantom Income or Phantom Alimony because Sue never actually receives the money, but she is required to pay the income tax on the funds as if she had received them directly.

After December 31, 2018. For divorces occurring after December 31, 2018, the Payee Spouse will not include alimony in his or her income, and therefore, none of these payments will be deemed income. In other words, Phantom Income or Phantom Alimony will be eliminated.

Characterization as Alimony or Child Support no longer an Issue after December 31, 2018

Until January 1, 2019. Until January 1, 2019, alimony payments are deductible by the Payor Spouse but child support payments are not. Therefore, property settlement agreements should clearly identify the character of each payment as deductible alimony or non-deductible child support. If a Payor Spouse fails to pay the full amount in any given month, the payments are first allocated to child support, regardless of whether the parties agree otherwise.

After December 31, 2018. For divorces occurring after December 31, 2018, this allocation is no longer required because there is no difference in the tax treatment between alimony and child support – neither are deductible.

Personal Exemptions Eliminated as of January 1, 2018

Prior to January 1, 2018. Prior to January 1, 2018, each taxpayer was entitled to a personal exemption for himself/herself, his/her spouse, and his/her dependents. In 2017, the personal exemption was \$4,050 per person, and it was subject to a phase-out if the taxpayer's adjusted gross income exceeded \$261,500 (single) or \$287,650 (head-of-household). Only one parent could claim the personal exemption for a child, which made it a frequent subject for negotiation in divorce settlements.

After December 31, 2017. While the provisions in the Tax Act concerning divorce and alimony take effect on January 1, **2019**, the elimination of the personal exemption took effect on January 1, **2018**. However, the provision eliminating the personal exemption sunsets in 2025, and barring any Congressional action, the personal exemption will be reinstated in 2026. Therefore, divorce decrees entered into after January 1, 2018 should include an allocation of the personal exemption but only for years after 2025.

Child Tax Credit Increased as of January 1, 2018

Prior to January 1, 2018. Prior to January 1, 2018, if you claimed your child as a dependent, you were not only entitled to claim a personal exemption for your child, but you were also entitled to claim the Child Tax Credit, which was \$1,000 per qualifying child under the age of 17. The aggregate amount of Child Tax Credits was phased out by \$50 for each \$1,000 of adjusted gross income over \$75,000 for single filers and \$110,000 for joint filers. Neither the \$1,000 credit amount nor the adjusted gross income thresholds were indexed for inflation. To the extent the Child Tax Credit exceeded the taxpayer's tax liability, the taxpayer was eligible for a refund of his/her Child Tax Credit (an additional Child Tax Credit) equal to 15% of earned income in excess of \$3,000.

After December 31, 2017. Between January 1, 2018 and December 31, 2025, if you claim your child as a dependent, you are entitled to the Child Tax Credit, which has been increased to \$2,000 per qualifying child under the age of 17. The new Tax Act increases the adjusted gross income level where the credit would begin to phase out to \$200,000 for single and head of household filers and \$400,000 for married taxpayers filing jointly. This amount is still not indexed for inflation. The Act reduces the earned income threshold for the refundable portion of the credit to \$2,500. The Act provides that the maximum amount of refundable credit per eligible child is \$1,400, and also indexes the maximum amount refundable for inflation.

The new Tax Act has a wide-ranging effect on individuals and businesses. For more information regarding the new Tax Act, contact any of the attorneys in Helsell Fetterman's Taxation Group.

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