

## Tax Implications of Divorce After Tax Reform: Alimony, Property Divisions, Divorce Modifications, Child Credits

THURSDAY, AUGUST 22, 2019, 1:00-2:50 pm Eastern

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August 22, 2019

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**TAX IMPLICATIONS OF DIVORCE AFTER  
TAX REFORM: ALIMONY, PROPERTY  
DIVISIONS, DIVORCE MODIFICATIONS,  
CHILD CREDITS**

Sarah Robinson and  
Amanda Dernovshek

# AGENDA

- Tax Reform Changes – TCJA
  - Suspension of Itemized Deductions
  - Basis Increase
  - Alimony
  - Child Support and Related Issues
  - Head of Household
  - Impact on Premarital Agreements
- Property Division
  - Retirement Assets
  - Trust Planning
- Wealth Transfer Planning and Divorce

# Tax Reform Changes

# TAX CUTS AND JOBS ACT OVERVIEW

- TCJA was signed into law in December 2017, effective January 1, 2018.
- TCJA was sweeping tax legislation, affecting individuals and businesses in several respects.
- Today's presentation will cover the ways in which the TCJA may affect divorced taxpayers, as well as certain planning opportunities related to the Act.

# SUSPENSION OF ITEMIZED DEDUCTIONS (JAN 1, 2018 – DEC 31, 2025)

- Certain divorce-related fees and costs used to be deductible as miscellaneous itemized deductions subject to the two percent floor (§ 67)
  - Obtaining – but not paying – taxable alimony (§ 212(1); Reg. §1.262-1(b)(7));
  - Structuring settlements or property divisions to produce desired tax effects (§ 212(3));
  - Obtaining a support trust to make taxable payments (§ 212(1)); and
  - Preparing, submitting and enforcing a QDRO (§ 212(1)).
- These fees and costs are no longer deductible until January 1, 2026. If alimony is not includable in gross income, fees and costs associated with obtaining alimony will not be deductible at all.

# BASIS INCREASE STILL AVAILABLE

- Expenses arising in connection with a divorce attributable to gaining property or defending title to property may be capitalized and added to basis. (Reg. § 1.212-1(k); *Gilmore v. United States* 245 F. Supp. 383 (DC-CA 1965)).

# ALIMONY

- TCJA changed the tax consequences of alimony significantly
- Divorce judgments & settlements finalized before January 1, 2019 = Old Rules (IRC 71/215)
- TCJA repeals IRC 71/215 for judgments & settlements finalized **after January 1, 2019**

# OLD ALIMONY RULES

- Apply to judgments and settlements:
  - Finalized before January 1, 2019; **and**
  - Not modified after December 31, 2018 **with statement that TCJA rules apply**

# OLD ALIMONY RULES

- Payor deducts alimony above-the-line (IRC 215)
  - Regardless of source of income (savings)
- Payee includes alimony in taxable income (IRC 71)
- May agree to treat alimony as **not** alimony
  - Not deductible by payor or includible by payee

# NEW ALIMONY RULES

- Apply to judgments and settlements:
  - Finalized after December 31, 2018; **or**
  - Modified after December 31, 2018 **with statement that TCJA rules apply**

# NEW ALIMONY RULES

- Payor may **not** deduct alimony
- Payee does **not** include alimony in income (**lower tax bracket lost**)
- No ability to designate which payments are deductible alimony – federal law is mandatory
- The alimony deduction will not be restored after December 31, 2025.

# WHAT IS ALIMONY?

- **Cash** payment to or on behalf of (ex)spouse
  - Not debt instrument / contract assignment
- **Under** a written divorce or separation instrument
  - Involuntary – Not payments before divorce unless *pendent lite* court order or separation agreement
- Payor's liability to make payments does not continue after recipient's death

# WHAT IS ALIMONY?

- Separate households when payment is made
  - One-month exception if preparing to depart
- No joint federal income tax return
- Instrument does not designate the payment as **not** alimony, deductible by payor, or includible by recipient
  - By agreement, court order, or separate writing
  - Retroactive changes order ignored, unless correcting mistake

# WHAT IS ALIMONY?

- Payments “on behalf” of spouse to third party:
  - Made at written request, consent, or ratification of payee spouse
  - Writing must declare intent that treated as alimony
  - Writing must be received by payor spouse prior to the date of filing federal income tax return for the tax year in which payment is made

# WHAT IS ALIMONY?

- Payments “on behalf” of spouse to third party:
  - Discharge any legal obligation (housing costs, tax, tuition, food, clothing, etc.)
  - Payment of housing costs to extent of **payee’s** interest
    - Owned by payor = no deduction
    - Jointly owned = half deduction
  - Payment of life insurance premiums only to the extent of the **payee’s** interest (all incidents of ownership)

# EXCESS ALIMONY RULES

- Three-year retroactive recharacterization of front loaded alimony
- Applies to the extent that:
  - 3rd year payments exceed 2nd year payments by >\$15,000
  - Average 3d/2d year payments exceed 1st year payments by >\$15,000 (excluding above)
- Exceptions for cessation due to remarriage, etc.



# WHAT IS CHILD SUPPORT?

- A payment that is **fixed** for the support of a child of the payor spouse is **not** alimony
- Fixed if reduced based on or can be associated with contingency relating to child
  - E.g., within 6 months of age 18 or 21

# TAXATION OF CHILD SUPPORT

- Generally, no deduction or inclusion by either party
  - Alimony treatment sometimes preferred
- Previously, custody of child affected right to claim personal exemptions
  - Eliminated post-2017

# NEW CHILD SUPPORT RULES

- Custody of child still affects:
  - Head of household status
  - Child tax credit
  - Dependent care credit

# “NEW” CHILD TAX CREDIT (TJCA)

- IRC 24 - Credit for up to \$2,000 (up from \$1,000) qualifying child with a refundable amount of up to \$1,400 per child
  - Phaseout now begins at \$200,000 (\$400,000 MFJ) per TJCA through 1/1/2026
- Qualifying Child:
  - Under age 17 at the end of the tax year
  - Child, stepchild, or foster child and their descendants (and others)
  - Dependent doesn't provide over one half of own support
  - Same principal place of residence for more than half the year
  - Other requirements

## “NEW” CHILD TAX CREDIT (TJCA)

- General Rule – the parent with whom the child resided for the greater period of time during the year (§152(e)(1)). This is the “custodial parent.”
- If nights are equal, parent with the higher adjusted gross income
- Custodial parent may assign the credit to a noncustodial parent (Form 8332)
  - Consider spouse’s AGI to avoid phase-out

# DEPENDENT CARE CREDIT

- IRC 21 – Non-refundable credit for 20% (up to 35% for taxpayers w/ <\$43k TI) of employment-related expenses in caring for “qualifying individuals”
- Capped at \$3,000 for one child and \$6,000 for two or more
- **Qualified Individual** - Taxpayer’s child who is under the age of 13 or incapable of self-care, and who lives at the same principle place of abode as the taxpayer for more than one-half of the year

# DEPENDENT CARE CREDIT

- QERE = household and care expenses paid to enable taxpayer to be gainfully employed during tax year
- **Primary** reason for paying must be to assure well-being and protection
- **Examples:** (Not food, clothing, and education)
  - Cook
  - Babysitter
  - Housekeeper
  - Cleaning person
  - Child care outside of the home

# DEPENDENT CARE CREDIT

- Custodial parent usually entitled to credit
- **Custodial parent** = Parent with whom the child lived for more nights during tax year
  - If nights are equal, parent with the higher adjusted gross income
- Credit not assignable, but can decide which parent is the custodial parent if 50/50 custody

# EDUCATIONAL CREDITS

- **American Opportunity:** Up to \$2,500 per student for each of four years of tuition, fees, and course materials
- **Lifetime Learning:** 20% of up to \$10,000 (AGI phaseouts) of qualified tuition & fees paid for education (other than A.O.)
- Deductible in divorced to parent who claims child as dependent, without ability to assign

	2017	2018 - 2025
Dependency Deduction	\$4,050	\$0 (§ 151(d)(5))
Child Tax Credit	\$1,000	\$2,000
Phase Out of Child Tax Credit – Joint Filers	Begins at \$110,000 of AGI	Begins at \$400,000 of AGI (eliminated at \$480,000) (§ 24(h))
Phase Out of Child Tax Credit – Married Filing Separately	Begins at \$55,000 of AGI	Begins at \$200,000 of AGI (eliminated at \$240,000)
Phase Out of Child Tax Credit – Head of Household	Begins at \$75,000 of AGI	Begins at \$200,000 of AGI (eliminated at \$240,000)

# HEAD OF HOUSEHOLD FILING STATUS

- Head of household filing status is available for taxpayers if he or she:
  - Is unmarried on the last day of the year (or deemed unmarried under §7703(b))
  - Maintains a home which is the main home for a qualifying child for more than half the year
    - Son, daughter, grandchild, stepchild, adopted child, foster child, sibling, niece/nephew
    - Younger than age 19 (or a student younger than age 24)
    - Doesn't provide more than half of his or her own support
  - Pays more than half the cost of maintaining the home for at least half the year
  - Can claim the dependency exemption or child tax credits for the qualifying child (even if the taxpayer does not actually claim the deduction or credit)

# HEAD OF HOUSEHOLD FILING STATUS LESS BENEFICIAL (JAN 1, 2018)

- Phase out of preferential “head of household” tax brackets for single parents making more than \$51,800.
- Standard deduction increase for head of household taxpayers who don’t itemize deductions.
  - In 2019, standard deduction for head of household taxpayers is \$18,350 (compared to \$12,200 for single taxpayers)
- Relatively small preference for tax rates on long term capital gains and qualified dividends.
- Tax bracket preference for head of household status will reappear in 2026.

# NEED TO REVISIT EXISTING PREMARITAL AGREEMENTS

- Premarital or marital property agreements entered into prior to Jan 1, 2019 likely do not qualify as written separation agreements under the 2017 Tax Act for purposes of grandfathered treatment under the alimony deduction rules.
- Any agreements that required a certain dollar payment, or assumed that alimony payments would be taxable to the payee and deductible by the payor should be revisited.

# USING SEVERABILITY CLAUSE

- Possible Impact of Severability Clause

- A severability clause in a premarital agreement may contain a requirement that the parties renegotiate a particular term in the agreement if the term is invalid, illegal or incapable of being enforced.
- If the agreement contains a requirement that the spouse who receives support payments after divorce must include the payments in his gross income, that requirement will be incapable of being enforced.

# IMPACT OF ELIMINATION OF ALIMONY DEDUCTION

- **Future Premarital Agreements**
  - Ensure negotiations take into account the fact that alimony is now nondeductible.
  - Consider maintaining flexibility to modify terms or adjusting amount of post-divorce support if alimony becomes deductible again.
- **Existing or Future Divorce Proceedings**
  - Ensure family lawyers and judges take into account the fact that alimony is nondeductible when determining appropriate support

# Property Divisions

# QDROs

- Qualified Domestic Relations Order (QDRO)
- Available to divide retirement assets, at or after divorce
  - 401(k) and other defined contribution plans
  - Pension plans
  - Some nonqualified plans
- Statutory and plan rules – Coordinate with plan administrator
- Payment generally taxable to payee spouse unless rolled-over
- Consider waiver of survivor benefits in pension plan

# NONQUALIFIED DEFERRED COMPENSATION

- Often overlooked and misunderstood
  - Usually, contractual rights only
  - Different rules from “qualified plans”
- Divisibility depends on terms of plan or agreement
  - Obtain copies and up-to-date account statements
- Revenue Ruling 2002-22
  - Transfer of stock options and unfunded NQDC
  - Gain on exercise of options and income on NQDC included by transferee spouse; No gain to transferor spouse
    - Potential exception if **unvested**

# NONQUALIFIED DEFERRED COMPENSATION

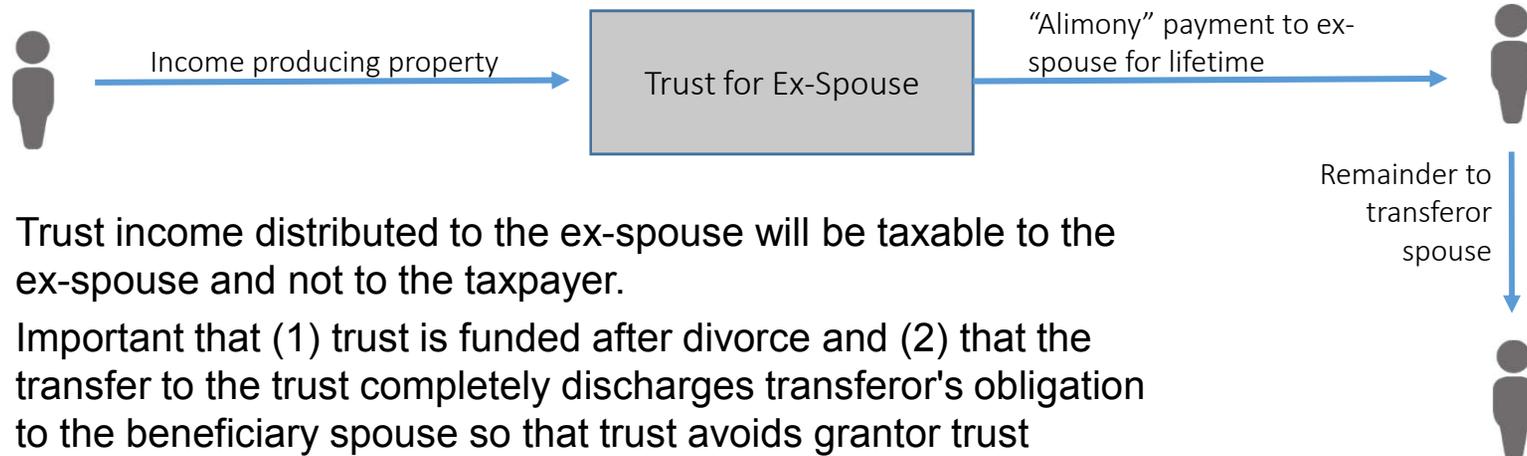
- FICA taxes are due on NQSO and NQDC to the same extent as if not transferred
  - Due on exercise of NQSO or vesting of NQDC
  - Withheld and W-2 reported for **employee** spouse
- Income tax withholding due on exercise of NQSO or payment of NQDC
  - Report on non-employee spouse 1099-MISC



# MINIMIZING COST OF ELIMINATION OF ALIMONY DEDUCTION

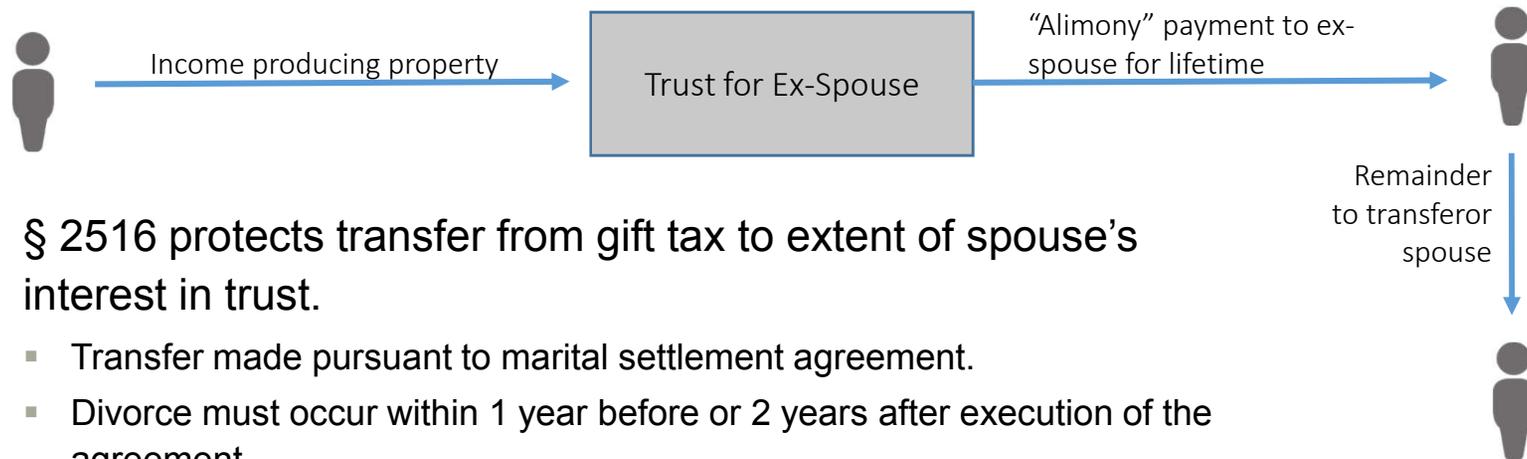
- Transfer Assets with Right to Receive Future Payments of Taxable Income
  - Interests in individual retirement accounts – must be transferred after divorce to avoid current taxation to owner of account (§ 408(d)(6)).
  - Interests in qualified retirement plans – transfer effected through qualified domestic relations order (§ 401(a)(13)(B)).
  - Interests in installment obligations (§ 453(g)).

# TRUST PLANNING TO MINIMIZE COST OF ELIMINATION OF ALIMONY DEDUCTION



- Trust income distributed to the ex-spouse will be taxable to the ex-spouse and not to the taxpayer.
- Important that (1) trust is funded after divorce and (2) that the transfer to the trust completely discharges transferor's obligation to the beneficiary spouse so that trust avoids grantor trust treatment.
- § 1041 protects transfer of appreciated property from income tax even if transfer is made in discharge of support obligation

# TRUST PLANNING TO MINIMIZE COST OF ELIMINATION OF ALIMONY DEDUCTION



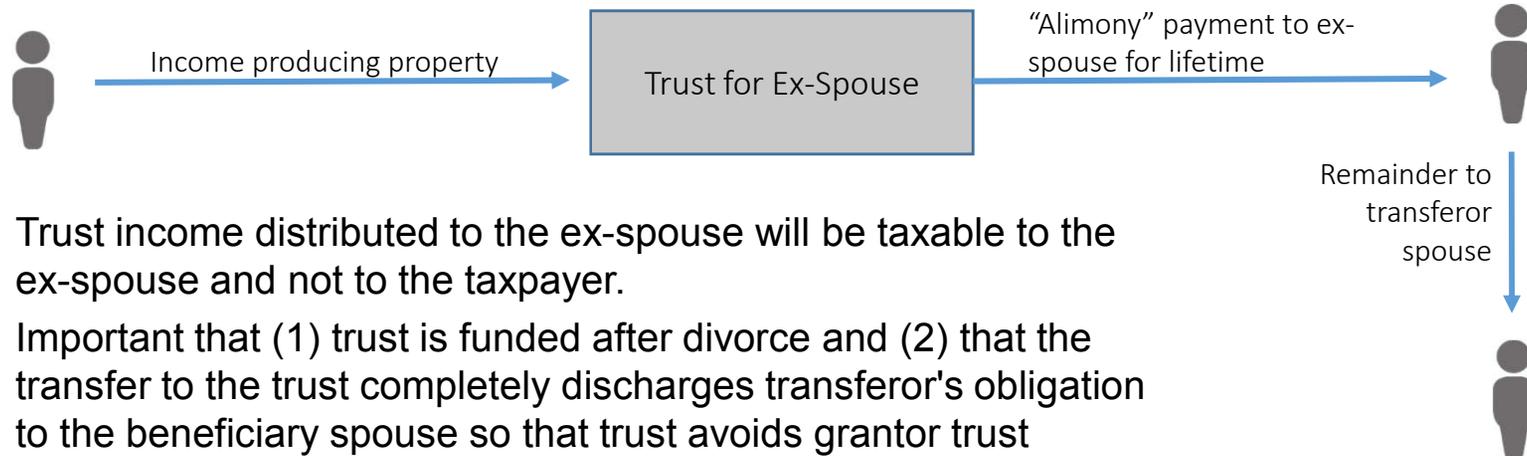
- § 2516 protects transfer from gift tax to extent of spouse's interest in trust.
  - Transfer made pursuant to marital settlement agreement.
  - Divorce must occur within 1 year before or 2 years after execution of the agreement.
- Under Treas. Reg. 25.2702-1(c)(7), § 2702 does not apply if the requirements of § 2516 are satisfied and the remaining interests are retained by the other spouse.

# Wealth Transfer Planning

# MINIMIZING COST OF ELIMINATION OF ALIMONY DEDUCTION

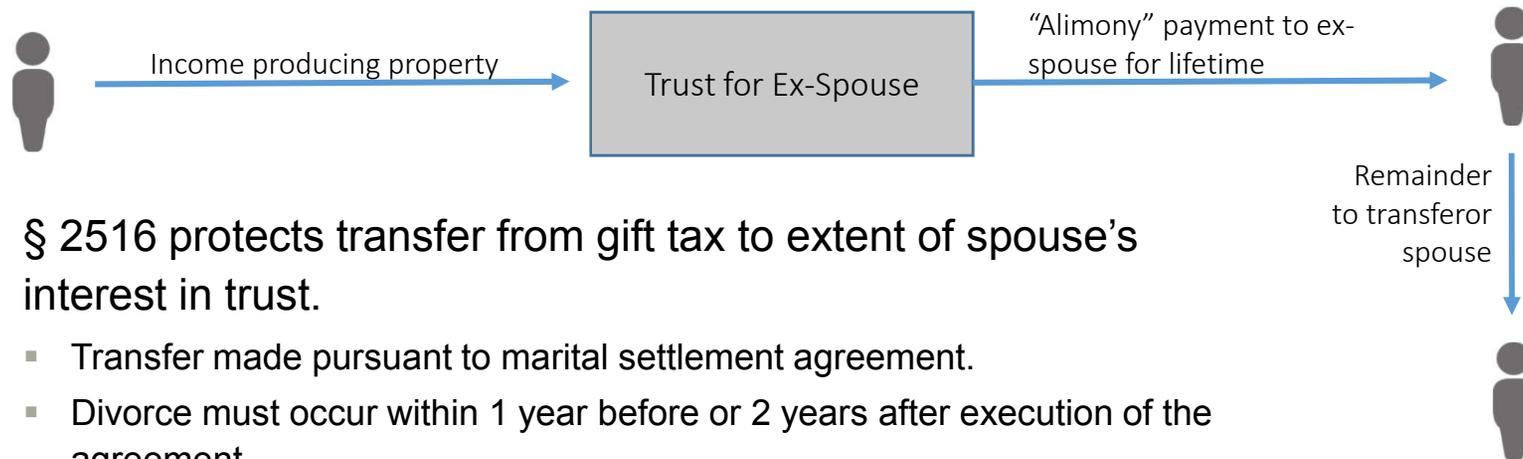
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# TRUST PLANNING TO MINIMIZE COST OF ELIMINATION OF ALIMONY DEDUCTION



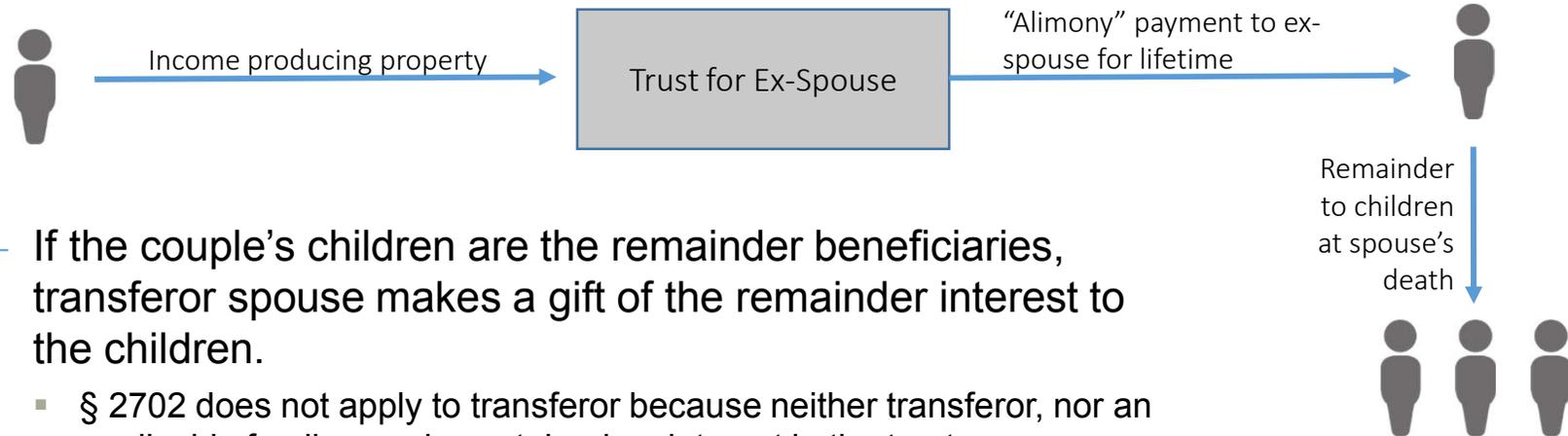
- Trust income distributed to the ex-spouse will be taxable to the ex-spouse and not to the taxpayer.
- Important that (1) trust is funded after divorce and (2) that the transfer to the trust completely discharges transferor's obligation to the beneficiary spouse so that trust avoids grantor trust treatment.
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# WEALTH TRANSFER PLANNING IN CONNECTION WITH DIVORCE



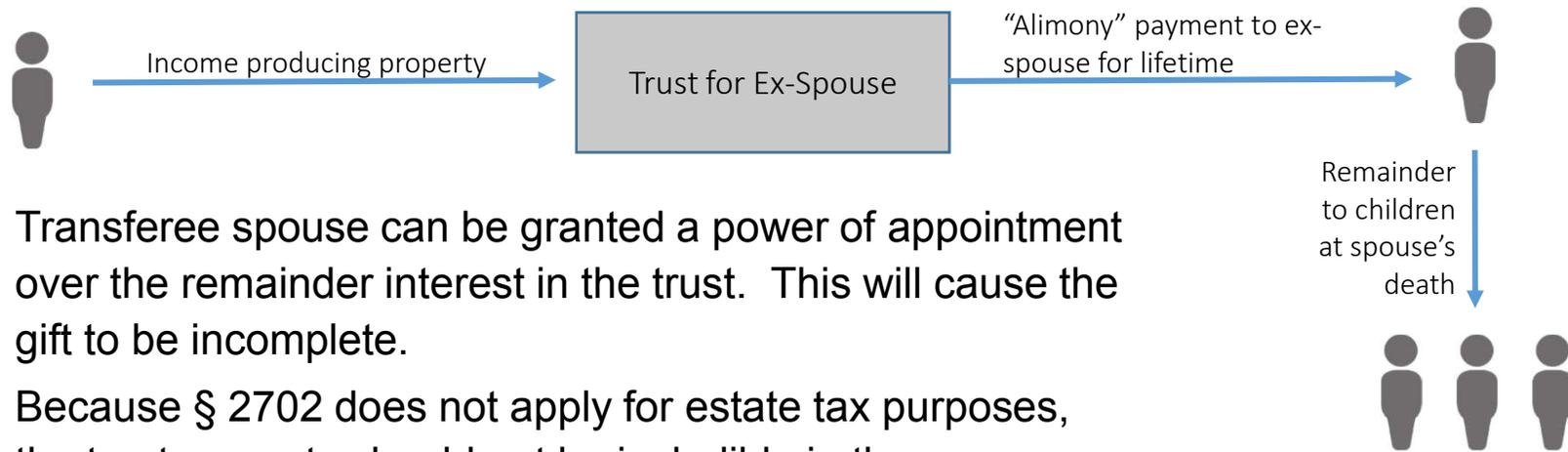
- If the couple’s children are the remainder beneficiaries, transferor spouse makes a gift of the remainder interest to the children.
  - § 2702 does not apply to transferor because neither transferor, nor an applicable family member retained an interest in the trust.
- Problem for beneficiary spouse because of the “joint purchase” rule under § 2702.

# APPLICATION OF JOINT PURCHASE RULE (§ 2702(c))

- An individual who acquires a term interest in property as part of the same transaction in which a child acquires a remainder interest will be treated as having acquired the whole interest and as having transferred the remainder interest to the child.
- An individual who transfers a remainder interest in property to a child must value her transfer to the child as if his retained interest had a zero value. As a result, he will be treated as having made a gift with a value equal to the value of his retained interest to the extent of the value he provided for that interest.
- An individual who receives a term interest in a trust in a transaction covered by § 2516, is likely to be caught by the joint purchase rule.

# AVOIDING THE IMPACT OF § 2702

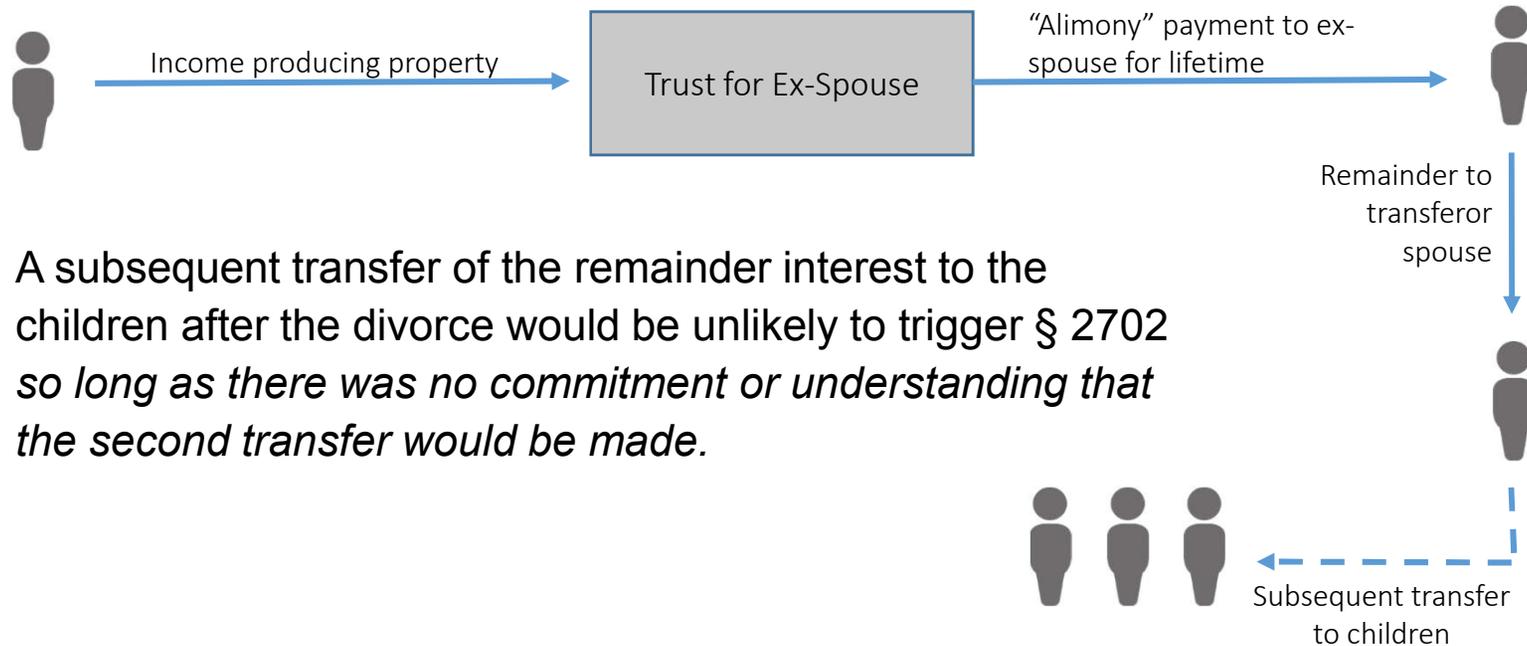
- Incomplete Gift by Transferee Spouse



- Transferee spouse can be granted a power of appointment over the remainder interest in the trust. This will cause the gift to be incomplete.
- Because § 2702 does not apply for estate tax purposes, the trust property should not be includible in the ex-spouse's gross estate if he or she dies holding this power

# AVOIDING THE IMPACT OF IRC § 2702

- Delaying the Transfer to Junior Family Members



- A subsequent transfer of the remainder interest to the children after the divorce would be unlikely to trigger § 2702 so long as *there was no commitment or understanding that the second transfer would be made.*

# AVOIDING THE IMPACT OF § 2702

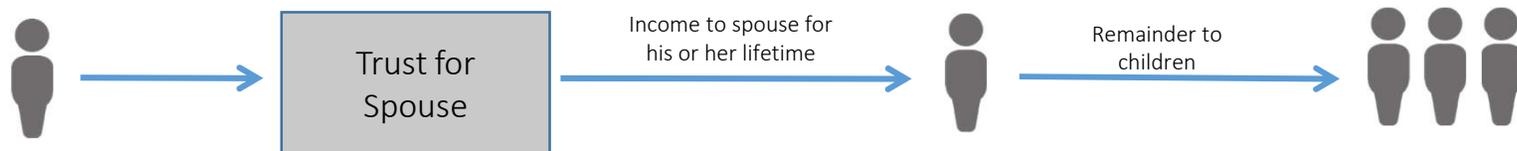
- More Traditional Tools
  - Qualified Annuity Interest
  - Qualified Personal Residence Trust

# APPLICATION OF IRC § 682

- IRC § 682
  - If spouses are divorced or separated, the amount of income one of them is entitled to receive from a trust created by the other (the “grantor”) will be included in the recipient’s gross income, not in the gross income of the grantor.
  - True despite any other provision of the Internal Revenue Code, including the grantor trust rules.

# IMPORTANCE OF § 682 TO DIVORCED GRANTORS

- A trust in which the grantor's spouse holds an interest during marriage is likely to be a grantor trust of which some or all of the income will be taxed to the grantor
- Under § 672(e), transferor treated as holding any trust interest or power held by an individual to whom the grantor was married at the time of the power's creation.



- Does not cease to operate after the transferor and his or her spouse are divorced.
- The grantor in most cases used to be protected from income tax liability on some or all of the trust income by the operation of § 682(a).

# IMPACT OF § 682 REPEAL

- Effect of Repeal of § 682
  - Repeal is effective for spouses whose divorce or separation instruments are executed after Dec 31, 2018.
  - Repeal applies to trusts that were created before Jan. 1, 2019 as well as those created after Dec. 31, 2018.

# IMPACT OF § 682 REPEAL

- Trusts Most Likely to Cause Grantor to be Taxed After Divorce
  - Family trust in which grantor's spouse is a discretionary beneficiary ("Family Trust" or Spousal Lifetime Access Trust ("SLAT")).
  - Inter vivos qualified terminable interest trust ("QTIP Trust").
  - Qualified personal residence trust ("QPRT") in which the grantor's spouse has an interest.

# IMPACT OF § 682 REPEAL

- Restructuring the Family Trust or SLAT
  - Consider distributing trust assets to spouse and terminating trust.
  - Consider removing the spouse as a beneficiary by means of an amendment power in the trust agreement or a decanting permitted under state law or the trust agreement.
  - Consider maintaining the spouse's status as a beneficiary but requiring in the marital settlement agreement that the spouse reimburse the grantor for the income taxes attributable to trust income that the spouse is entitled to receive.

# IMPACT OF § 682 REPEAL

- Restructuring the Inter Vivos QTIP
  - Consider dissolving the QTIP with an outright distribution of all of the trust property to the beneficiary spouse.
  - Consider having the grantor purchase the QTIP's remainder interest from the remainder beneficiary and simultaneously terminating the trust.
  - Consider leaving the QTIP in place, but requiring in the marital settlement agreement that the beneficiary spouse reimburse the grantor for the income taxes attributable to trust income that the spouse is entitled to receive.

# IMPACT OF § 682 REPEAL

- Restructuring the QPRT
  - Grantor of a QPRT generally retains the right to live in the residence that was transferred to the QPRT for a period of years.
  - Spouses will generally agree that one of them should have the right to live in the residence after the divorce, which would require a transfer of an interest from one spouse to the other.
    - Transfer of an income interest in a trust from the transferor spouse to the other spouse can be protected from gift tax if required by the marital settlement agreement and if divorce occurs after the agreement.
    - In order to avoid grantor trust status for the transferor spouse, the transfer of the QPRT income interest should take place after the divorce.

# THANK YOU!

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