Post-TCJA Tax Considerations in Divorce Matters

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The 2017 Tax Cuts and Jobs Act (TVJA) was one of the most comprehensive changes to the Internal Revenue Code (IRC) in history. Several changes implemented by the TCJA, including taxation of alimony, greatly affect divorce and matrimonial practices.

For divorces occurring on or before Dec. 31, 2018, alimony (or separate maintenance) payments made by one ex-spouse to another are treated as income to the payee and a deduction to the payor. Generally, the payor of alimony is the higher wage earner and likely has a higher effective tax rate than the payee. As a result, pre-TCJA treatment of alimony is a form of “income shifting,” which potentially causes a loss in federal revenue.

The TCJA, however, changed that. For divorce occurring on or after Jan. 1, 2019, alimony is no longer treated as income to the payee, nor a deduction to the payor. As such, it is necessary to consider TCJA tax treatment of alimony when structuring marital or property settlement agreements. Practically speaking, the amount of post-TCJA alimony should be less because the payor must now pay income tax on every dollar, with no offsetting deduction, while the alimony payment is tax-free to the payee. The only winner, of course, is the federal government.

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There are several caveats practitioners should consider. The first wrinkle is that under New Jersey law, the tax treatment of alimony has not changed. For New Jersey purposes, alimony is still treated as income to the payee and a deduction to the payor. Therefore, it is helpful to prepare pro forma federal and state returns for both spouses when negotiating the amount of alimony.

MODIFICATION AGREEMENT

Second, the amount of alimony is often subject to subsequent modification. If a divorce occurs on or before Dec. 31, 2018, and the terms of the alimony are modified on or after Jan. 1, 2019, then alimony is still taxed under pre-TCJA rules unless the modification agreement specifically states that TCJA rules apply to the modification. If the parties intend to maintain pre-TCJA rules, it is best practice to draft the modification agreement clearly stating such intent, as well as specifically citing the pre-TCJA date of the original settlement agreement.

CHANGES TO AFTER-TAX INCOME

Finally, settlement agreements for divorces occurring pre-TCJA were based upon the parties' after-tax income at the time of the divorce. While the TCJA not only changed taxation of alimony, it also drastically altered the overall income tax system. As such, each party's after-tax income may be significantly different (for better or worse) when considering the changes implemented by the TCJA. These changes include the following:

- Reduced individual and corporate tax rates
- Revised marginal tax brackets
- Increased standard deduction
- Elimination of the personal exemption
- Limit on the state and local tax (SALT) deduction
- Increased child tax credit
- Increased Alternative Minimum Tax (AMT) limits
- Section 199A deduction for Qualified Business Income (QBI)
- Elimination of miscellaneous deductions.

To further complicate matters, numerous changes implemented by the TCJA will sunset after Dec. 31, 2025.

TAXATION OF TRUSTS

Another change dealing with divorce under the TCJA involves the taxation of trusts. If, for example, John establishes a trust for the benefit of his wife, Mary, during the marriage, and the income of that trust can be distributed to Mary without the consent of an adverse party (as defined in the IRC and the regulations thereunder), then John is treated as the owner of the trust for income tax purposes under IRC § 677(a) (1). As a result, any income earned by assets held in the trust will be included on John's personal income tax return. IRC § 677 is part of what are commonly referred to as the "grantor trust rules," which specify the circumstances in which the grantor of a trust (also known as a settlor or trustor) is treated as the owner of the trust for income tax purposes. Such a trust is known as a "grantor trust."

However, the grantor trust rules also prescribe "once a spouse, always a spouse," which means that the trust in the above example continues to be a grantor trust even after John and Mary are divorced. Prior to the TCJA, IRC § 682 fixed this result and "turned off" the grantor trust status upon divorce. Unfortunately, the TCJA repealed IRC § 682. Therefore, in addition to the changes to taxation of alimony, practitioners must be mindful of any tax implication resulting from grantor trusts after divorce, otherwise the client may receive an unwelcomed surprise when filing their first post-divorce income tax return.

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