How Changing Tax Laws Could Affect Divorcing Couples

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Couples who have made the decision to divorce in 2018 may be surprised to learn that changes in personal and business income taxes will impact the financial outcomes of their divorce. It is unclear if the new tax rules will make divorce more or less difficult to negotiate legally or financially.

Couples who divorce before December 31, 2018 will be covered under the existing IRS rules for alimony, but will also have many law changes that impact their net disposable income calculations. Those who divorce after this date will be subject to the new rules established by the Tax Cuts and Jobs Act, enacted in 2017.

This article takes a look why alimony came to be, how it is currently being taxed, and how it will be taxed after December 31, 2018.

The History of Alimony

Historically, alimony was awarded to the wife during a divorce because women had no rights to property when they were married to men, even their own inheritances. In addition, women experienced many barriers to outside employment, and any income they earned was transferred to their husbands.

If the wife was not considered "at fault" for the divorce, she was entitled to alimony after the divorce. Currently, the need for alimony has been reduced because of the introduction of equitable property division in divorce actions, and the increased ability of women to earn their own income.

According to a Marquette Michigan University study in 2016, only 10% of cases in recent years have included alimony awards (down from 25% 40 years ago). More states are implementing formulas to reduce and limit alimony awards, and the courts often use the value of marital property for determining an alimony award.

Current Taxation of Alimony

Current alimony tax laws shifts the tax responsibility from the payer—who presumably has more income and is in a higher tax bracket—to the recipient—who should have less income and be in a lower tax bracket—by allowing the payer to deduct the alimony amount and requiring the recipient to pay taxes on the alimony. This arrangement lessens the tax burden on the divorced couple, who is already having to support two separate households, because the person in the lower bracket will pay less tax.

Taxation Under New Tax Law

Under the Tax Cuts and Jobs Act, it seems like the lower income spouse would get tax relief because the payer will be covering the taxes on alimony. Unfortunately, this change will actually reduce the amount of disposable income to be shared between the two parties because more taxes will be paid on the alimony amount. This will especially negatively affect less wealthy couples whose alimony payments may be based on sharing net paychecks. When combined with child support obligations, there is just simply less money to share.

Here are some other ways the new tax laws might impact a divorcing couple:

- The standard deduction has roughly doubled for all filers, but the valuable personal exemption has been eliminated. This means parents can no longer claim dependents on their return, which could disproportionately affect larger families. In general, the fewer dependents you have, the better off you are under the new tax changes.
- Other deductions disappearing under the new act include: casualty and theft losses, unreimbursed employee expenses, tax preparation expenses, other miscellaneous expenses subject to the 2% adjusted gross income(AGI) cap, moving expenses, and employer subsidized parking and transportation reimbursement.
- Capital gains rates remain unchanged, but they do not line up with the new tax brackets. Under previous law, 0% - 20% long-term rates were unevenly distributed among income levels. Now, the three rates are divided between only three income levels. But the 3.8% Medicare surtax that applied to high earners remains the same and has the same income thresholds.
- The child tax credit is still available for children under age 17 and has doubled from $1,000 to $2,000; the income threshold for phaseout has also increased.
- The interest on home equity lines of credit (HELOC) is no longer tax deductible.
- The mortgage interest deduction is capped for mortgages up to $750,000.
- The state and local income tax (SALT) deduction, including property taxes, is capped at $10,000.

One will have to analyze which tax deductions may still be tradable and whether these deductions will favorably impact either party. Higher standard deductions may or may not make itemizing worthwhile. The other concern is if these tax law changes reappear in some other form after they sunset in 2026, will they remain renegotiable by the parties?

Effects of Dependency Exemption Elimination

There will no longer be the opportunity for former spouses to trade dependency exemptions to achieve equitable tax relief when personal exemptions are eliminated under the new rules. The idea of now having undifferentiated family support be tax neutral may fuel some of the most contentious issues of divorce around child custody.

While the dependency exemption is being eliminated, the child tax credit remains. Generally, only one parent may claim all the tax-related benefits for a child, including the child tax credit, the dependent care credit, the exclusions for dependent care benefits and the earned income tax credit (EITC). The noncustodial parent may only claim a dependency exemption for a child under a special IRS rule if the custodial parent releases the exemption and all other IRS requirements are met. (For related reading, see: *Earned Income Tax Credit: Why Millions Pay No Tax*.)

Only the custodial parent may claim the dependent care credit and the EITC because the child must meet residency requirements. In 2018, the child tax credit doubled and is worth up to $2,000 per qualifying child under the age of 17. The earned income threshold for phaseout has increased to $200,000 for single filers. These tax credits may seem like a boon to lower- and middle-class families and could even influence custody negotiations.

Alternate Payment Options

Alimony can be paid in the form of third party direct payments, such as mortgage payments, home equity line of credit payments or property taxes, which often allow the lower-income spouse to stay in the marital home. The paying spouse previously benefited from direct payment of these expenses by taking them as tax deductions.

However, the new limits for mortgage interest deduction, the elimination of HELOC interest and the cap on property taxes diminish the incentive for spouses to collaborate to keep one of them in the house. The paying spouse faces competing options if they own a separate home and are limited with respect to reduced tax deductions.

Examining legal, tax and financial options to achieve equitable results is an essential part of every divorce. And with the changes to the tax rules taking effect in 2018, it's important to carefully explore all of your options before signing on the dotted line.

(For more from this author, see: *What Divorcees Should Know About New Social Security Rules*.)

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