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Divorce Planning After the 2017 Tax Act

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INTRODUCTION

President Trump signed tax reform legislation (Pub. L. No. 115-97) into law on December 22, 2017 (the ''Act,'' formerly known as the ''Tax Cuts and Jobs Act,'' but the bill had to drop that name in order to satisfy Senate procedural rules.) The Act is the most sweeping tax legislation to be enacted in decades and will impact matrimonial cases, as well as planning, in profound ways.

The Act will significantly transform divorce settlements, including its monumental change related to the taxation and deductibility of alimony payments, which for divorce decrees and separation agreements entered into after 2018 will eliminate the deduction to the payor for alimony payments and the inclusion in gross income of the payee. In addition, the Act may impose consequences on existing divorce agreements. For example, might the reduction of state and local tax (SALT) deductions for a high-income spouse in a high-tax state have sufficient economic impact to create a financial hardship? Might the SALT changes depress property values upsetting the intended implications of a negotiated settlement? If a client owns a moving company, might the elimination of the tax deduction for moving expenses have a significant negative economic impact on that business and affect the ability to continue payments? The Act has such wide ranging, and as of yet undetermined, impact that practitioners will simply have to be alert for the different, and potentially significant, impact, on different clients. Apart from the economic impact, would a court consider any of these changes sufficient to justify reopening an existing divorce arrangement for changed circumstances?

Favoring stability and consistency, a high standard has to be satisfied in order to modify the provisions of a divorce agreement or judgment of divorce. For support provisions contained in a divorce agreement that is incorporated, but not merged, into a judgment of divorce, generally, the party seeking the modification needs to demonstrate a substantial change in circumstances. For support provisions that are court-ordered or contained in a divorce agreement that is merged into a judgment of divorce, the party seeking the modification needs to show a change in circumstances. To set aside a divorce agreement, the moving party would need to meet the difficult standard of proving fraud, duress, overreaching, or unconscionability. Likewise, for reformation or rescission of a divorce agreement, including its property settlement terms, certain contract principles are available, including mutual mistake and unjust enrichment. It remains to be seen whether the new issues that arise by virtue of the Act will constitute enough of a change in circumstances or other basis to warrant a modification.

529 PLANS

In cases involving children, it is commonplace for divorce agreements to include provisions governing the payment of college expenses and set forth terms governing any existing 529 college savings plans. However, the Act changes the 529 plans in significant ways that most likely no matrimonial settlement agreements have anticipated. The qualified expenses under 529 plans will now include elementary and high school education of up to $10,000 per year. Permissible distributions can also be made to religious educational institutions.

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As 529 plans previously were reserved for payment of college expenses, many divorce agreements executed prior to the Act will undoubtedly fail to include provisions requiring that the funds be reserved for payment of college expenses. Consequently, it remains to be seen how the Act's expansion of the use of 529 plans could undermine the intent of existing divorce agreements. For 529 plans, may balances initially earmarked for college expenses be dissipated earlier to pay for non-college educational expenses, contrary to the parties' original intent? It is important for the non-title owner to exercise any rights he or she may have to review the account statements to track how the funds are being spent and to consult with his or her lawyer about taking action to address the issue before it may be too late to prevent dissipation of the funds.

What happens if the divorce agreement is silent as to the application of the 529 funds? What if one ex-spouse was obligated to pay for private pre-college education and the agreement is not clear on limiting 529 plans for college? Can that spouse distribute funds from a 529 plan to pay his or her obligations for elementary school? What if that dissipates the funds intended for college? If the agreement is ambiguous regarding use of the funds, which is likely because it is doubtful one could have contemplated this change, what happens then? It remains to be seen whether this may constitute a change of circumstance warranting a modification. Those affected would be well-advised to review existing divorce agreements in order to ascertain whether the agreement specified college-only expenses be paid from a 529 plan and whether that would suffice to restrict the spouse account owner from using funds earlier.

PERSONAL EXEMPTIONS

The Act eliminates personal exemptions, after 2017, for a taxpayer (other than for disability trusts described in §642(b)(2)(C)), the taxpayer's spouse, and any dependent.[1] The suspension does not apply to taxable years beginning after December 31, 2025. This change might have a significant effect on divorce arrangements where the spouses expressly negotiated which spouse would be permitted to claim which exemptions for their children. In many divorce cases, this tax benefit was likely negotiated as a trade-off for another concession. Perhaps, the economic impact is equal between the spouses and simply a tax benefit lost. But what if one spouse negotiated to claim the exemptions for all of the children and counted that estimated tax benefit in the divorce negotiations and did not consider that benefit to be zero? Is that a basis to revisit or adjust the agreement? What about the fact that the provision sunsets at the end of 2025? What happens now?

> *Example:* How will this new rule affect a divorce agreement where the parties negotiated which parent would be entitled to claim the personal exemption for their children? Assume the divorce agreement provided for the following: ''The husband shall hereafter claim Child 1 and Child 2 on his separate income tax returns and the wife will sign an IRS Form 8332 or its equivalent concerning the husband's right to do so in 2012 and future years. The wife shall not claim any child on her separate income tax returns. Each party hereby authorizes the other to attach a copy of said form to his or her respective income tax returns.'' If the husband and wife negotiated in good faith for the husband to claim exemptions that have now been legislated away, is there any recourse? If the marital settlement agreement did not have any provisions addressing changes in tax law, likely the value involved would not support the cost of reopening the agreement, especially if the elimination of exemptions sunsets. If the agreement were challenged to address this, might that process subject the parties to the new alimony rules? It appears not (see below) unless they expressly agree to it.

ALIMONY

As stated above, the Act overhauls the traditional treatment of taxability and deductibility of alimony payments. Under the Act, alimony payments will no longer be deductible by the payor spouse nor will they be includible in the income of the payee spouse. The effective date indicates that this new rule will apply to any divorce or separation instrument as defined in §71(b)(2) executed after December 31, 2018, or for any divorce or separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that these amendments made by the Act apply to such modification. Practitioners should consider adding a provision to any agreement in process that if the law is changed as provided in the Act, the agreement can or must be renegotiated (or expressly provide that there will be no renegotiation even if the future amendments to the tax law change the tax effects of payments to be made under the agreement). It might, in some instances, be worth specifying in agreements being negotiated be-

[1] All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

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fore 2019 both the alimony payment amount under the existing law pre-2019 when it can be deducted and the alimony payment amount under the Act in the event the agreement is not concluded in time. It is also important that both matrimonial practitioners and accountants should put all divorced clients paying or receiving alimony on notice that the agreement lawfully may be modified to bring it under the new law if that proves advantageous for them.

As this suggests, the primary direct impact the Act has on matrimonial matters is the elimination of the tax deduction for alimony for the payor on new divorce agreements executed after December 31, 2018, as well as not including alimony as gross income to the payee. While this has been suggested as a simplification measure, it also appears to be a response to the report that, all too often, the payor spouse would deduct the alimony payment but the payee spouse would not report the income, thereby creating a costly whipsaw of lost tax revenue for the government. It seems strange that Treasury could not find a way to match the deduction with the income, particularly considering the deduction would be disallowed unless the payor spouse included the payee spouse's social security number on the tax return. Instead of using computers to match up the income with the deduction, Congress decided instead to upend matrimonial arrangements, effectively forcing review and potentially modification of alimony payment agreements. Further, it will change the way alimony is negotiated going forward.

The fact that payor spouses may be in higher tax brackets than payee spouses should make this a net revenue increase for the Treasury. No doubt this was a factor behind the change, to add revenue to the Act impact calculations. But the new rules preventing the deduction of alimony will cost divorcing taxpayers more out of pocket for this same reasons, and may ultimately harm payee ex-spouses as payor's are unwilling to pay as much knowing the payment is not deductible. Theoretically, payee spouses could be hurt by as much as the net tax difference from prior law (the value of the alimony deduction to the higher bracket payor spouse less the tax cost to the lower bracket payee spouse). This change could have a dramatic impact on every divorce in negotiation now or during 2018. When this change becomes effective, it will change the landscape for all future divorces in ways that may not be readily determined.

The tax implications of divorce agreements are often part of a complex negotiation between spouses and their respective counsel. Many times, the spouse who receives alimony has been able to negotiate an increased payment because the deduction will reduce the tax liability of the spouse paying alimony as opposed, for example, to nondeductible property transfers or child support payments made by the payor spouse. Will the elimination of the alimony tax deduction reduce the bargaining power of the spouse receiving the alimony payments? Will it reduce alimony awards and disincentivize the payor spouse from paying more sizable alimony awards?

Even though the Act was only recently signed into law, unlike most other changes made to the taxation of individuals made permanent, there has already been talk of a future administration repealing or changing many of its provisions. What will happen, should that occur, to property settlement agreements that are executed while the alimony deduction was eliminated? Should matrimonial practitioners risk complicating the divorce agreement more by trying to contemplate the possibility of future legislative change at a time when the sea-change of nondeductible alimony has not yet been digested? If an agreement to renegotiate the provision if the law changes is included, what will be the consequences? If the agreement provides for the renegotiation of the alimony provision, when it comes time to do so, will it open the floodgate to renegotiate other nonrelated terms in order to get the deal done?

The Act's significant change regarding the taxability/deductibility of alimony also stands to have a material impact on previously executed prenuptial agreements. Many prenuptial agreements include terms governing alimony in the event of a divorce and mirror the existing law in providing that alimony payments will be deductible by the payor. What happens when it comes time to divorce if the payments are no longer eligible to be deductible by the payor and taxable to the payee? While some pre-existing prenuptial agreements may include a provision specifying that the alimony payments will be readjusted if these tax treatments are no longer available, the vast majority of agreements will be silent on the issue. For couples who entered into a prenuptial agreement, it is strongly recommended to review the agreement and address with their attorneys whether to proactively enter into a postnuptial agreement in order to confront the issue head on.

Disrupting matrimonial agreements by changing the historic treatment of alimony will create considerable havoc. This change from long historic treatment of alimony payments will create new issues that everyone involved must evaluate. It also remains to be seen how judges synthesize the new dynamics in making alimony awards.

Thus, every divorce agreement, prenuptial agreement and post-nuptial agreement in process should address the consequences of the new law, and should be completed prior to the effective date of the new provision if that is preferable, and contemplate the possible change by future legislation. The reality is

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that given the contentious nature of many of these agreements and the costs involved, that may not be practical. The results could be problematic for many.

> *Example:* Husband and wife are negotiating during a contentious divorce, which negotiations may or may not conclude by the end of 2018. Counsel inserts a clause into the draft matrimonial settlement agreement: ''The parties acknowledge that the payment of alimony has been a negotiated amount that reflects the intention that alimony payments will be deducted by the payor for income tax purposes. Should this marital settlement agreement (MSA) not be completed, executed and effective prior to January 1, 2019, when alimony is scheduled to become nondeductible the parties shall have Big City CPA firm calculate an equivalent nondeductible payment. If either party does not agree with that recalculation, then the parties agree to submit this single issue to binding arbitration subject to the express condition that no other provisions of the executed MSA shall be reopened by that step.''

Terms of Alimony

There are other facets to the alimony tax change as well. The terms of many divorce agreements were expressly negotiated under long-time alimony deduction rules to meet the requirements of §71. Thus, divorcing parties have long bent the objectives they might have intended to the requirements of the tax law. For example, for alimony to have been deductible, there must be no liability to make any payment for any period after the death of the payee. So, even where the parties might have preferred to continue a payment beyond the death of the payee spouse, perhaps for some specified period, parties had agreed that payments should cease once the payee spouse passes. This concession may have been accompanied by an agreement to pay an additional amount (in the form of property settlement, for example) to make up for the lost post-death payments.

If a property settlement agreement is revised to permit this, or if a new agreement violates this, what happens? Will this in some instances provide more flexibility for matrimonial attorneys to negotiate an agreement tailored to the circumstances instead of to meeting the artificial statutory requirements for the historic alimony deduction?

Alimony vs. Property Settlement

Current law also included rules to prevent transforming property settlement payments, which are not deductible, into deductible alimony payments, by requiring the recapture of front-loaded or excess payments.[2]

> *Example:* Wife made deductible alimony payments in the first year to husband, and those payments exceeded the average payments in the second and third year by more than $15,000. The excess payments must be recaptured in year three by wife, including the excess in her income, and the husband/payee would receive a deduction for that amount in computing adjusted gross income.

How will these rules interact with the new law and the 2019 elimination of the alimony deduction? If divorcing parties negotiate a settlement with payments that would violate the alimony frontloading rules, if alimony is not deductible it may have no tax impact (although there may be other ramifications). However, if the law is changed in the future to reverse these changes, returning to the historic treatment of alimony as tax deductible, what happens if an ''alimony'' payment is negotiated that violates these rules and in the following year the law changes?

Alimony vs. Child Support

The Conference Agreement states that under the House bill ''The treatment of child support is not changed.'' While the tax status of child support as being nondeductible by the payor and nonreportable by the payee is unchanged, the dynamic surrounding the negotiation of child support may be profoundly changed. The alimony rules also contain protections to prevent a payor from disguising nondeductible child support as deductible alimony. Thus, if alimony payments are reduced under the terms of the property settlement agreement on the happening of a contingency relating to children, then an amount equal to that reduction will be characterized as nondeductible child support, rather than as deductible alimony.[3] Should divorced parties renegotiate provisions in their agreement to better meet personal objectives because this restriction will no longer have any tax impact? What happens to such arrangements if the new law is modified by future changes in the law? Is that simply too speculative to address?

What is the effective date of these changes? The Conference report provided as follows: ''. . .the conference agreement delays the effective date of the provision by one year. Thus, the conference agreement is effective for any divorce or separation instrument executed after December 31, 2018, or for any divorce or

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[2] §71(f).

[3] §71(c)(2).

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separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by this section apply to such modification.'' This appears to indicate that any existing pre-2019 agreement can be modified and still be subject to current (pre-Act) law. So, any modification of any marital agreement may reopen negotiations on whether the tax status of the prior agreement should be changed.

The Act makes conforming amendments to several other sections including §682 dealing with so-called alimony trusts.

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CONCLUSION

The Act will transform matrimonial practice. In an area where people desire predictability and finality, the Act creates speculation and uncertainty. The direct changes to exemptions, 529 plans, and in particular, alimony, will require every matrimonial practitioner to revise standard forms and provisions and rethink many traditional strategies. Caution will have to be exercised in estimating the economic impact of settlements while all these changes are assimilated. To make matters more difficult, and much more complicated, it may take quite some time for clients to understand the impact of the many other provisions of the Act on their tax positions.

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