



Ed Slott

Divorce 2019: How to use IRAs and 401(k)s to ease future alimony planning

A change in the tax law could now help both parties

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By Ed Slott

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Under **The Tax Cuts and Jobs Act**, alimony will not be tax-deductible when paid under divorce and separation agreements executed in 2019 and later. And alimony will be tax-free to recipients. This turnaround from the current treatment of alimony, as tax-deductible to payers and taxable income to recipients, reverses law that has been in place since 1942.

Existing (pre-2019) divorce agreements will not be affected by the new rules. Alimony will remain

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For post-2018 divorces, the new tax rules will apply, and the couple will most likely have less after-tax income available for alimony. The IRS' take will increase.

Any first impression that the recipient of alimony will be helped by receiving it tax-free is misleading. Reducing after-tax income available to pay alimony leaves less in the overall pot to draw from.

But there is a new — and unexpected — opportunity in the law change as well. The new tax rule can increase the value of tax-deferred retirement savings in divorce negotiations.

To be deductible, alimony payments must meet several conditions — notably, they must be paid in money. But for nondeductible alimony, these conditions are irrelevant. For instance, nondeductible alimony can be funded with property. A lump-sum payment of alimony might be funded with stock shares, real estate or even retirement plan funds transferred from a 401(k) under a qualified domestic relations order (QDRO), or a balance from an individual retirement account (state law permitting).

At the same time, the new rules will mean that alimony recipients will have less ability to fund IRA contributions. Taxable alimony income qualifies one to fund IRA contributions because it's treated as compensation (the same as wages), but tax-free alimony will not qualify as compensation,

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Planning opportunity

A tax-saving opportunity suggests itself when recipients of alimony can't create tax-favored savings for themselves, but payers of alimony can transfer tax-favored account balances to them through a property settlement or perhaps as alimony itself.

Example: John and Mary negotiate an alimony agreement in 2019. After the divorce, John will be in the 35% tax bracket and Mary in the 22% bracket. They are considering having John transfer pretax retirement savings to her. These may come from a traditional IRA, 401(k) or other pretax savings plan. John can do this through a property division or perhaps even a lump-sum payment of alimony.

Mary receives the transfer tax-free, as property settlements aren't taxable and alimony is tax-free to her, and withdrawals will be taxable at her lower tax rate (the same as alimony would have been taxed under the pre-law rules). If she is at least age 59½, she can withdraw the funds at any time to spend and not owe an early distribution penalty. And she obtains tax-favored retirement savings that may benefit her for the rest of her life.

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IRA withdrawals. John meets his obligation to Mary by paying with pr-tax dollars, effectively gaining a tax deduction.

The result can be a win-win scenario in which the IRS' take is slashed, giving the parties more to divide. The alimony recipient may also put extra value on receiving lifetime retirement benefits, which justifies taking less cash from the payer.

Of course, there are possible problems with substituting retirement funds for conventional alimony. A recipient spouse under age 59½ may need cash alimony to pay living expenses, and withdrawals of retirement funds could be subject to a 10% penalty.

In addition, the payer of alimony who transfers retirement funds instead of cash will lose the extra benefits of having tax-favored investments that the recipient gains.

Including tax-deferred IRA or 401(k) funds in future divorce negotiations is now an option that divorcing couples and their financial planners can use to meet their particular needs in new, creative ways.

(More: [Post-tax-time IRA checkup](#))

Ed Slott, a certified public accountant, created the IRA Leadership Program and Ed Slott's [Elite IRA Advisor Group](#). He can be reached at irahelp.com.

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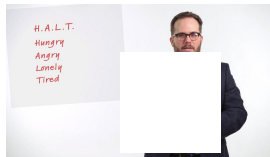
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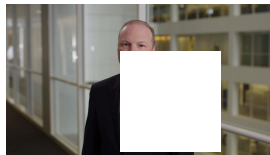
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