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OPINION

Alimony and the TCJA: a common misconception

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Under the Tax Cuts and Jobs Act of 2017, alimony will no longer be tax deductible to the payor and no longer tax includable to the payee, effective Jan. 1, 2019.

The law was a shock to many, particularly divorce lawyers, most of whom had gotten used to the way things had been for the last 75 years. There is a saving grace in the Tax Cuts and Jobs Act, or TCJA, however: Qualifying agreements and modifications can be grandfathered into the old taxability treatment subject to certain requirements.

Specifically, unless the parties opt-in to the new law, the TCJA applies to "decree[s] of divorce or separate maintenance or written instrument[s] incident to such … decree[s]" executed after Jan. 1, 2019.

To unwind this legislative convolution: The old taxability provisions can apply to your qualifying pre-2019 agreement unless you both agree that you don't want them to. Still a mouthful, but that's the way Congress wrote it.

The biggest misconception about alimony and the TCJA, frequently repeated in the lay media, and even by legal commentators, is that the qualifying instrument must be a final divorce judgment. It does not. You do not necessarily have to have a final divorce judgment by the end of the year to be grandfathered.

Lawyers, who like to be "better safe than sorry," may prefer to have a divorce judgment, but when you are fighting this issue out in December of this year without the luxury of time, it's worthwhile to take a closer look at what is actually required.

Procrastinators can rejoice. The TCJA continued the requirement from IRC s.71 that a payment made to or on behalf of a spouse or ex-spouse pursuant to a "written instrument incident to [a divorce decree]" qualifies for alimony treatment.

The TCJA further sets forth that such instruments are "as defined in s.71 … as in effect before" the TCJA. Presumably, the case law from the past several decades interpreting the clause remains relevant and binding.

So, basically, in many instances, all a couple may need to qualify for grandfathered alimony treatment is a contract by Dec. 31, that is a "written instrument incident to [a divorce decree]" pursuant to the statute. The "contract" here is no more prescriptive than a common law "meeting of the minds" contract — except that, unlike in the common law, it must be in writing. A separation agreement signed by the parties andapproved by the court should do; no need to wait for a final judgment of divorce 90 to 120 days later. A separation agreement not yet approved by the court should also suffice.

But it doesn't even have to be that formal. Two Tax Court opinions illustrate the flexibility of the "written instrument incident to a divorce" requirement.

A Tax Court Memorandum Opinion, Leventhal, T.C. Memo. 2000-92, made clear a "meeting of the minds" requirement, particularly that there be a "clear statement in written form memorializing the terms of the support between the parties." In this case, one spouse's written assent to a letter proposal of support by the other spouse was a sufficient writing to bring it within IRC s.71.

Moreover, Leventhal tells us, it was not necessary to articulate a specific amount of support so long as "there is an ascertainable standard with which to calculate support amounts."

A Tax Court Summary Opinion, Micek, T.C. Summ. Op. 2011-45 (2011), is also instructive for our purposes. Here, the couple separated in 1997 and entered into an oral agreement in 1999 that the husband pay the wife alimony of $1,250 per week. Later that year, the husband signed a "spousal support affidavit" agreeing, or reaffirming, the payment of alimony in the same amount.

In 2003, the husband stopped paying because he became disabled and, presumably, was unable to earn income. The wife's attorney then wrote to the husband, inquiring as to why the alimony stopped. Think about this: There is still no divorce pending at this point, the wife hasn't signed anything yet, and the wife's lawyer wrote the letter described above four years after the husband started paying alimony.

A few more years go by. At some point — the opinion does not make clear when — the husband filed for divorce. Presumably satisfied that neither party had the means to support the other, the parties' agreement incorporated in the divorce judgment mutual waivers of present and future alimony.

In 2009, the IRS filed a notice of deficiency disallowing the husband's alimony deductions for the years 2000 to 2003, the period prior to the divorce during which the husband was paying alimony to the wife. All of the payments at issue were made prior to the filing of the divorce.

The husband took the matter to Tax Court. The issue before the court was whether the alimony was paid pursuant to a "written instrument incident to [a divorce decree]."

The Tax Court agreed with the taxpayer, finding that alimony was paid pursuant to such an instrument and, therefore, deductible to him and includible to his ex-wife. The Tax Court reasoned that (1) the so-called "spousal support affidavit" signed by the husband in combination with (2) the letter from the wife's attorney inquiring as to why he had stopped paying alimony (which evidenced her client's understanding that alimony was to be paid) was sufficient to qualify under IRC s.71. That is, a written instrument (the affidavit) signed by one party and the letter from the wife's attorney was together a sufficient "written instrument" that evidenced the meeting of the minds between the parties.

The biggest misconception about alimony and the Tax Cuts and Jobs Act is that the qualifying instrument must be a final divorce judgment. It does not. You do not necessarily have to have a final divorce judgment by the end of the year to be grandfathered.

Considering the significant time gap between the instrument and the divorce filing, it is striking that Micek did not focus on the requirement that the "written instrument" be "incident to [a divorce decree]." We might deduce from Micek that timing is not dispositive to the "incident to" requirement but that it is, rather, a sort of "totality of the circumstances" analysis.

Indeed, the parties had been living separately and the husband had been paying alimony for several years, and, eventually, they got around to making de jure what had been de facto. From this, it would appear a logical construction that the alimony payments at issue, though made several years before a complaint for divorce, were "incident to" a divorce.

In any event, to play it safe, the practitioner should endeavor to have the contract executed while a divorce is pending or imminent in order to meet the "incident to divorce" requirement — so, unlike Mr. Micek, nobody is relying on the Tax Court to save the day.

Bottom line: a divorce judgment is not the only way, under the TCJA, to get the preferential tax treatment that alimony judgments today can enjoy.

In the context of Micek and the "incident to" discussion above, consider prenuptial or postnuptial agreements. Although there is no case law on the issue, these do not appear to be qualifying agreements pursuant to IRC s.71. They are not, in the same sense as the Micek agreement, "incident to" a divorce decree, even if one of the parties filed for divorce shortly after signing.

Two additional issues merit consideration: (1) Must a 2018 agreement contain a present award of alimony, and (2) How should the practitioner handle 2018 temporary orders of alimony followed by a 2019 (or later) divorce judgment?

As for (1), it is unclear whether a 2018 agreement that contains no present award of alimony but preserves the rights of the parties to future alimony would qualify for preferential retroactive treatment.

On the one hand, the TCJA's new alimony rules exempt from its application "any divorce or separation instrument" executed before 2019. That would suggest that any agreement would suffice, whether or not it includes a present award of alimony.

On the other hand, elsewhere in the TCJA alimony is defined, subject to other conditions, as payments made to or on behalf of a spouse pursuant to a "divorce or separation instrument." Arguably, read together, there needs to be a present award of alimony — actual payments must be made (or required).

In light of the uncertainty, the cautious practitioner would do well to include a requirement of a present payment of alimony, if only a nominal amount, and a statement in the agreement to the effect that the parties intend the agreement to qualify for tax preferential treatment per the TCJA.

As for (2), temporary orders pose challenges when dealing with the TCJA and retroactivity. If there is a 2018 temporary order of alimony followed by a 2019 divorce judgment, the temporary order is extinguished. With that, the link to retroactivity may be severed. That is not clear, of course, but it is a possibility.

Therefore, the practitioner may want the judgment to incorporate the temporary order so as to preserve best as possible the benefits of a qualifying retroactive instrument.

This position is generally consistent with the IRS regulations for alimony pursuant to the Tax Reform Act of 1984, which also dealt with the issue of the retroactive application of that law to instruments entered prior to that act's effective date of Jan. 1, 1985.

Those regulations (which, by the way, have been "temporary" for 34 years) made clear, for example, that if a 1985 divorce judgment incorporated without change the terms of a 1984 instrument, that 1985 judgment would be grandfathered under the then pre-existing tax law. 26 CFR s1.71-1T (Q-A #26).

The 1984 regulations do have one caveat that the practitioner may wish to consider: The subsequent judgment must incorporate the terms of the prior instrument "without change."

Clearly, we don't know if the IRS will interpret the TCJA's alimony provisions in the same way, but it may be worthwhile to at least consider these regulations as we venture into uncharted territory. If the IRS were to adopt this position with respect to the TCJA, it would certainly be problematic in the event a 2018 judgment provides for a nominal alimony payment and a post-2018 judgment calls for a larger payment.

In the months ahead, while many labor to complete agreements by year's end, we can hope for clarifying guidance from the IRS. In the meantime, especially in the gray areas, practitioners would do well to let clients know, in writing, where there are uncertainties as to whether their agreements will be grandfathered. MLW

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