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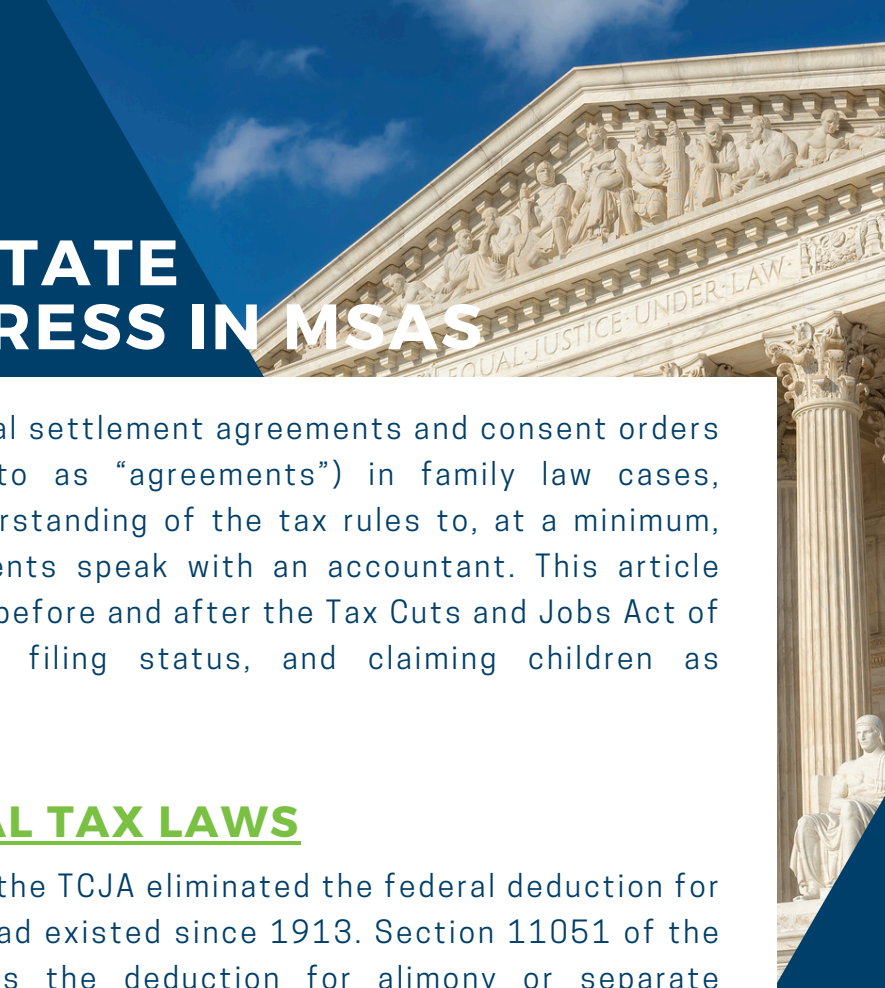
FEDERAL AND NJ STATE TAX LAWS TO ADDRESS IN MSAS



When drafting and negotiating marital settlement agreements and consent orders (hereinafter collectively referred to as "agreements") in family law cases, attorneys should have a basic understanding of the tax rules to, at a minimum, know when to recommend that clients speak with an accountant. This article discusses the tax implications both before and after the Tax Cuts and Jobs Act of 2017 (TCJA) related to alimony, filing status, and claiming children as dependents.

I. ALIMONY

FEDERAL TAX LAWS

Effective as of December 31, 2018, the TCJA eliminated the federal deduction for alimony. Until then, this deduction had existed since 1913. Section 11051 of the TCJA states, "this section repeals the deduction for alimony or separate maintenance payments from the payor spouse and the corresponding inclusion of the payments in the gross income of the recipient spouse." A comprehensive history of the taxation of alimony is provided in an article by Tessa Davis at the University of South Carolina School of Law in 2018, titled "A Human Capital Theory of Alimony and Tax."

Summarily, alimony was one of the tax targets to raise revenues as an offset to other tax cuts to reach "reconciliation," which enabled passing the tax bill with a simple majority in the Senate. The tax act effectively lowered the top individual federal tax rate from 39.6% to 37%, lowered the corporate rate from 35% to 21%, and created the Qualified Business Income (QBI) deduction of 20%, in addition to several other tax incentives, including an increased child tax credit.

To pay (or offset) for the tax reductions, several long-standing tax laws were changed, phased out, or eliminated. As relevant to this article, changes to the tax law included the elimination of alimony deductions and taxability. As most family law practitioners are aware, alimony payments were previously deductible to the payor spouse and taxable as income to the payee spouse. Although it would appear upon a cursory review that the tax revenue should be equalized if alimony is deductible to the payor spouse and taxable as income to the payee spouse, this was untrue.

The annual costs to the federal government from allowing payor spouses to deduct alimony was $6.9 billion(1). This deficit occurred because generally the payor was in a higher tax bracket than the payee. When the payor deducted their alimony payments, then the payor was moved to a lower tax bracket. However, when the payee claimed alimony as income they were not often moved into a tax bracket that was as high as the payor before their deduction for alimony. For example, if the payor was in the 39.6% tax bracket and the recipient payee was in the 25% bracket, the federal government was losing tax revenue.

The question that eliminating the alimony deduction creates for family law practitioners is, should the net of tax to both parties be when negotiating alimony?(2)

Let's explore examples(3). Assume taxable income of $650,000 for Spouse A before the payment of alimony and taxable income of $25,000 for Spouse B before the receipt of alimony. Assume the alimony paid is $200,000 per year(4). Spouse B also qualifies for Head of Household Status, and Spouse A is Single using 2024 tax rates:

Filing Status	Pre TCJA Single Spouse A	Pre TCJA Head of HH Spouse B	Post TCJA Single Spouse A	Post TCJA Hd of HH Spouse B
Taxable before Alimony	$ 650,000	$ 25,000	$ 650,000	$ 25,000
Alimony	$ (200,000)	$ 200,000		
Taxable Income	$ 450,000	$ 225,000	$ 650,000	$ 25,000
Tax Federal	$ 129,395	$ 49,226	$ 200,832	$ 2,686
Tax State	$ 26,645	$ 10,293	$ 39,385	$ 500
Child Credit -one child		$ (2,000)		$ (2,000)
Total Tax	$ 156,040	$ 57,519	$ 240,217	$ 1,186
Alimony Non-taxable *			$ (144,000)	$ 144,000
Net After Tax	$ 293,961	$ 167,482	$ 265,783	$ 167,814
Spouse A Savings on deduction	$ 84,177			
Tax Differential	$ 24,659	Tax Saved by A Less Tax Paid by B		
* amount that equalizes spouse B under TCJA and Pre-TCJA				

The above tax differential is why the tax law drafters targeted alimony to offset the other tax cuts. To provide the recipient (Spouse B) with a similar net cash flow, the alimony percentage went from 32% of the gross income differential between the parties to about 23%. As a result, the calculation of the alimony payment would result in a reduction of 28% from the pre-law change amount, namely from $200,000 to $144,000. However, the payor (Spouse A) has less net income than before by $28,000 ($2,333 per month) or 14% of the deductible alimony.

Let's use a couple with a lower incomes:

	Pre-TCJA Single Spouse A	Pre-TCJA Hd of HH Spouse B	Post-TCJA Single Spouse A	Post- TCJA Hd of HH Spouse B
Taxable before Alimony	$ 200,000	$ 25,000	$ 200,000	$ 25,000
Alimony	$ (60,000)	$ 60,000		
taxable Income	$ 140,000	$ 85,000	$ 200,000	$ 25,000
Tax Federal	$ 26,642	$ 12,061	$ 42,868	$ 2,669
Tax State	$ 6,898	$ 2,550	$ 10,720	$ 500
Child Credit one child		$ (2,000)		$ (2,000)
Total Tax	$ 33,540	$ 12,611	$ 53,588	$ 1,169
Alimimony Non taxable			$ (48,000)	$ 48,000
Net After Tax	$ 106,460	$ 72,389	$ 98,412	$ 71,831
Tax Savings On Alimony	$ 20,048	Spouse A Old Law v New Law		
Tax Differential	$ 5,437	Tax Saved by A Less Tax Paid by B		

To provide the recipient (Spouse B) with a similar net cash flow, the alimony percentage went from 34% of the gross income differential between the parties to about 27%. The calculation of the alimony payment would result in a reduction of 20% from the pre-2019 amount, namely from $60,000 to $48,000. However, the payor (Spouse A) has less income by $8,000 ($667 per month) or 13.3% of the deductible alimony.

No matter where parties are in the income spectrum, the TCJA makes negotiating non- taxable alimony slightly more complex if the goal is to consider the net tax to each party.

Additionally, if alimony, which was previously taxable, was awarded or agreed upon before December 31, 2018, is changed *after* December 31, 2018, the modification can change the deductibility of alimony for tax purposes(5). If attorneys want to maintain the taxability of alimony payments, then there must be express language in the agreement that Section 11051 of the TCJA does not apply to the change.

1. Justin T. Miller, *Tax Reform Could Make Divorce a Whole Lot More Taxing*, Vol. 52, No. 2 Family Law Quarterly 303 (October 11, 2019) American Bar Association.
2. If considering the tax consequences to the parties, then using 33% of the parties' incomes is now more likely between 20% and 27% to account for a range of lost tax savings to the payor. This is dependent on the size of the incomes of the parties. Moreover, this endnote should not be viewed as suggesting there is a formula for alimony or utilizing factors outside of N.J.S.A. 2A:34-23.
3. These examples are simplistic to illustrate the point.
4. This article is not suggesting that $200,000 is the amount that should be paid between the parties. This article is providing this for illustration purposes only.
5. I.R.S. Publication 5307, at 10.

NEW JERSEY STATE TAX LAWS

Despite the changes by the TCJA to the deductibility of alimony, in New Jersey alimony may still be deductible to the payor and taxable as income to the payee for state income tax purposes pursuant to N.J.S.A. 54A:5-1(n). N.J.S.A. 54A:5-1(n) defines gross income as "[a]limony and separate maintenance payments to the extent that such payments are required to be made under a decree of divorce or separate maintenance but not including payments for support of minor children."

Additionally, the "New Jersey Tax Guide, Divorcing Your Spouse" states that alimony is still taxable/deductible for New Jersey state income tax purposes as long as the agreement or order does not specifically state alimony is non-taxable. The full excerpt is set forth below:

Alimony Received. If you receive alimony from your spouse or former spouse, it is taxable in the year you receive it. Alimony is not subject to tax withholding, so you may need to increase the tax you pay to New Jersey during the year to avoid a penalty. To do this, you can make estimated tax payments or increase the amount of state tax withheld from your wages by completing the NJ-W-4 form with your employer. Do not include payments for child support;

Alimony Paid. You can deduct alimony paid to or for a spouse or former spouse under a divorce or separation decree. Voluntary payments made outside a divorce or separation decree are not deductible. Do not include payments for child support.

Alimony paid to a spouse could be considered nontaxable if the divorce decree stipulates that the other spouse who is paying the alimony agrees not to claim it as a deduction. Alimony is taxable to the recipient under State law N.J.S.A. 54A:5-1(n). However, the Division would consider the terms of a divorce decree when deciding whether such a stipulation is allowable. You may be asked to submit a copy of the divorce decree so it can be reviewed by Division personnel.

From a practical perspective, family law attorneys should at minimum be aware that there is a difference in taxability of alimony in New Jersey. When drafting a martial settlement agreement, the determination about whether to expressly carve out whether alimony is non-taxable or "tax neutral" will likely depend on whether you are representing the spouse paying alimony or the spouse receiving alimony.

In the event the parties agree on that issue, language could be included in the settlement document as follows:

The parties agree that the alimony payment provided for in this Article shall be non-taxable for Federal and State income tax purposes. Each party agrees to file tax returns consistent with this Paragraph.

II. HEAD OF HOUSEHOLD FILING STATUS

If a couple is divorced before the end of the tax year - even if it is December 31 - then the couple is considered unmarried for the entire year for federal and New Jersey state tax purposes. As a result, each person will file on their own as either Single or Head of Household. The Head of Household filing status will result in a greater tax savings than filing as Single. However, Head of Household status for federal and New Jersey state tax purposes requires the taxpayer to pay more than half of the expenses of the household and have at least one qualifying child living with them for more than half the year, or at least 183 days(6).

The requirement of the Head of Household filing status to have a qualifying child for at least 183 days is problematic for parties with 50/50 physical custody arrangements, as neither party has more than 183 days.

If there is only one child, family law practitioners may want to consider including a provision in a marital settlement agreement that states the parties will alternate filing as Head of Household. As an example, language could state:

For Federal and State Income Tax purposes the parties shall alternate filing as Head of Household. In even years, Spouse A shall file Head of Household and have the child for 183 overnights. In odd years, Spouse B shall file Head of Household and have the child for 183 overnights.

Where there is more than one child, both parties can use the Head of Household deduction if the agreement states that one child stays with Spouse A for 183 days and the other child stays with Spouse B for 183 days.

An illustration of the federal tax savings from filing as Head of Household versus Single is set forth on the next page.

The impact of the filing status has much more meaning for the lower income party as a percentage of income than the higher income party.

SPOUSE A	Single	Head of HH	Difference
Adjusted Gross Income	$ 200,000	$ 200,000	
Standard Deduction	$ (14,600)	$ (21,900)	
Taxable Income	$ 185,400	$ 178,100	
Federal Tax	$ 38,160	$ 34,538	$ 3,622
Both filing status' would get a $2,000 per child credit so that is not a factor here to measure diffe			
SPOUSE B			
Adjusted Gross Income	$ 600,000	$ 600,000	
Standard Deduction	$ (14,600)	$ (21,900)	
Taxable Income	$ 585,400	$ 578,100	
Federal Tax	$ 177,207	$ 173,030	$ 4,177

In addition to addressing filing status in agreements, family law attorneys should keep the Head of Household status and requirements in mind when running child support guidelines.

III. CHILD TAX CREDIT

In agreements, many practitioners automatically provide a dependency exemption to each spouse or alternate between spouses each year if the parties only have one have only one child. Requirements to qualify for the credit are:

- Child must be under 17 by end of the year
- Must be a child
- Must be eligible to be claimed as a dependent
- Must live with the taxpayer (absent an without an agreement or form 8832)

However, the dependency exemption does not provide a benefit to all parties. For 2024, the child tax credit (CTC) is income dependent and provides a credit for qualifying dependents of $2,000 per child. However, if a party's modified adjusted gross income (MAGI)(7) exceeds $200,000(8), then the credit gets reduced by $50 per $1000 of MAGI over $200,000. In other words when the Single or Head of Household taxpayer has $240,000 of MAGI then no credit will be provided as they will receive no benefit from receiving the dependency exemption.

It may not make sense from a fairness perspective to provide a credit to a party who derives no benefit from it. This is especially true if the other party can receive a benefit from the deduction. In cases where one party is a high-income earner, instead of simply alternating the dependency exemption, practitioners may want to consider including the following language:

Spouse A shall be permitted to claim Child A as an exemption for Federal and State income tax purposes. Spouse B shall be permitted to claim Child B as his exemption for Federal and State income tax purposes. When the first child is emancipated, Spouse A shall claim the remaining unemancipated child in even years and Spouse B shall claim the unemancipated child in odd years. It is anticipated that Spouse B will not receive a benefit from claiming either child for tax purposes. In the event that Spouse B will not receive a benefit from claiming Child B (or the remaining unemancipated child), Spouse A shall be permitted to claim both children as exemptions.

The sample language provided above is intended to balance changes to the CTC and a party's income.

6. For purposes of this article, we are just discussing qualifying children. However, there are other qualifying dependents.
7. MAGI is adjusted gross income (AGI) plus the following, if any: untaxed foreign income, non-taxable Social Security benefits, and tax-exempt interest. MAGI does not include Supplemental Security Income (SSI) interest. For many people, MAGI is identical or very close to adjusted gross income. If a taxpayer's MAGI exceeds the above limits, their credit gets reduced by $50 for each $1,000 that their income exceeds the threshold.
8. The MAGI is $400,000 for married parties.

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