



Remember Alimony Recapture in 2018

Keep Up With the Calculations to Save Your Clients Money

By Sam Hubbard

By now, most divorce financial planners are aware that the recently enacted tax bill will end the favorable tax treatment of alimony payments for divorces finalized after December 31, 2018. However, for the remainder of this year, it is important to remain vigilant about the existing tax rules, especially as clients race to finalize their divorces before the new tax law takes effect.

One such rule is the often-overlooked concept of **alimony recapture**, which can have significant financial implications for your clients years after the ink has dried on their settlement agreements. If an alimony payor ignores this rule, they could see significant negative tax consequences in the third year following their divorce. On the other hand, if your client is the alimony recipient, it could provide an opportunity for a tax windfall in that same third year.

Since alimony recapture can impact your client for better or for worse, here's a rundown of what you need to know so you and your client's attorney have the upper hand:

WHAT IS THE RECAPTURE RULE?

Under the Tax Reform Act of 1986, the alimony recapture rule applies if alimony payments "decrease substantially" or end during the first three calendar

years after a divorce is finalized. "Decrease substantially" means that either:

- The amount paid in year three decreases more than \$15,000 from what was paid in year two; or
- The average of the amounts paid in years two and three, plus \$15,000, is less than the amount paid in year one.

POTENTIAL COSTS OF OVERLOOKING ALIMONY RECAPTURE

- Increased tax liability
- Higher tax bracket
- Expense of CPA to oversee IRS audit
- Penalty for filing incorrect tax return

THE RULE'S IMPACT

While the alimony recapture rule is rarely considered when negotiating a settlement, CPAs are increasingly aware of the rule and are advising their clients about it in the third year. If alimony recapture applies, alimony recipients can claim the recaptured amount and receive

an immediate tax break by deducting the recaptured amount from their taxable income.

On the flip side, people paying alimony must “recapture” the amount they had previously deducted from their taxes and pay taxes on that amount in the third year.

Let’s look at an example from the perspective of the payor. Assume the payor earns \$150,000 a year, pays \$55,000 annually in alimony, and later discovers that there is alimony recapture in the amount of \$20,000. For two years, the payor will report gross income of \$95,000 (\$150,000 minus \$55,000). However, in the third year, the payor must gross his or her income back up by the amount of alimony recapture (\$20,000), resulting in total taxable income of \$115,000.

The payor is not only responsible for paying taxes on money originally thought to be tax deductible, but may also be pushed into a higher income tax bracket as a result of the recaptured income.

But that’s not all.

Interestingly, by law the alimony recipient does **not** have to disclose alimony recapture to the ex-spouse. Therefore, if the alimony recipient claims the recapture amount in the third year without telling the ex-spouse, the payor will end up filing an inaccurate return. And since the alimony recipient is required to include the ex-spouse’s last name and social security number on the tax return, the income discrepancy will lead the IRS directly to the payor.

As a result, the IRS will likely audit the payor, who may then have to incur the expense of a CPA to help oversee and navigate the audit. In addition, the payor may be subject to a penalty from the IRS for incorrectly claiming income deductions.

AVOID THESE TWO CRITICAL MISTAKES

Miscalculating alimony recapture is widespread, so make sure to pay attention to these two common mistakes to avoid any issues down the line:

1. The amount of alimony recapture is frequently miscalculated because of a simple error: using an incorrect timeframe to compute each of the three years. To avoid this mistake, always compute alimony recapture using a calendar basis.

2. Delays when negotiating a settlement agreement can impact whether alimony recapture actually occurs. For example, a settlement agreement negotiated in April may not result in alimony recapture, but it might if the negotiations carry into October.

Therefore, it is important to adjust and re-compute alimony recapture each month during negotiations, even if the amount and duration of alimony has not changed.

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A WORKING EXAMPLE

Now let’s take an example of declining alimony payments and determine the alimony recapture amount and what it means. Let’s say that a divorce is finalized in September, and alimony is to begin in October at \$10,000 per month for 12 months, then drop to \$6,500 per month for 24 months.

- The calendar alimony amounts are:
 - Year 1: \$30,000 (3 months at \$10,000)
 - Year 2: \$109,500 (9 months at \$10,000 and 3 months at \$6,500)
 - Year 3: \$78,000 (12 months at \$6,500)
- The amount of alimony recapture is \$16,500.
- In the third year, the alimony recipient is able to reduce his or her taxable income in the amount of \$16,500, while the payor is now on the hook for paying taxes on these funds.

It is interesting and important to note that in the example above, if alimony began in April, not October, there would be no alimony recapture.

People paying alimony must **recapture** the amount they had previously deducted and pay taxes on that amount **in the third year.**

CALCULATING ALIMONY RECAPTURE

In the case of alimony recapture, a best practice is to provide your client's attorney with exact numbers and the impact of alimony recapture, as well as to re-compute the amount each month to ensure that recapture does not negatively impact your client.

You can refer to the free alimony recapture calculator on CoastalDivorceAdvisors.com for an accurate and fast way to determine alimony recapture amounts.

SUMMING UP

While alimony recapture is a little-known rule, it can have costly consequences if it is not considered prior to finalizing the settlement. With a potential influx of cases aiming to settle before year-end, make sure to keep it in mind during negotiations to provide your clients and their attorneys with the most value.



SAM HUBBARD
MBA, CFA, CDFA

Sam is the principal of Coastal Divorce Advisors, LLC, a firm specializing in divorce financial planning located in Savannah, Georgia. Sam is also the principal of Coastal Capital Management, LLC, a registered investment advisor.

For additional information, e-mail Sam@CoastalDivorceAdvisors.com or visit www.CoastalDivorceAdvisors.com.