TAX CONSIDERATIONS IMPACTING THE DIVORCE PROCESS

Presented by: Stewart C. W. Weiner, Esq.

I. INTRODUCTION

A. Family law attorneys concern themselves with issues such as division of property, custody (legal and physical), parenting time, child support and in some cases spousal support.

B. Tax considerations are always important and of paramount importance in the analysis and evaluations family lawyers provide to clients. The Tax Cuts and Jobs Act ("TCJA"), effective January 1, 2019, made some significant and impactful changes with respect to family law, its practitioners and those professionals who work with them.

C. In the time allotted to me, we will discuss a few tax issues impacted by the TCJA and mention some additional issues that are worthy of further discussion.

II. THE ISSUE OF DEPENDENTS IS NOW MORE IMPORTANT DURING NEGOTIATIONS

A. The increase in standard deduction from $6,350 ($12,700 joint) to $12,000 ($24,000 joint) has eliminated for many, including high income taxpayers, the issue of itemized deductions

B. Therefore, the standard deduction is more valuable than before.

1. The custodial parent is entitled to claim a qualifying child as a dependent.

2. The TCJA allows divorcing couples to negotiate qualified dependents, regardless of primary custody so long as the parties use IRS Form 8332.

3. Receiving the dependent also allows the recipient to use the child tax credit and tuition credits in appropriate situations, i.e., to be entitled to take a child care credit, the parent must have greater than 183 overnights for the year.

C. What happens in these situations:

1. If a parent and a non-parent both claim a child as their dependent, the "parent" wins, IRC Section 152(c)(4)(A)(i)

2. If both parents claim the child on their separate returns, the parent who has more overnights wins, IRC Section 152(c)(4)(B)(i)

3. If the child lives with each parent equally during the year, the parent with the highest adjustable gross income wins, Section IRC 152(c)(4)(b)(ii).

D. PRACTICE TIP. To avoid a dispute later on over dependents, obtain a signed IRS Form 8332 from the former spouse at or around the time the divorce decree is signed, much like the procedure used to obtain a quit claim deed from the former spouse.

III. SPOUSAL SUPPORT - THE NEW FRONTIER

A. Before January 1, 2019, spousal support was deductible by the payor, Section 215, and includible in income to the payee, Section 71.

B. Up until the TCJA, the law governing spousal support deductibility dated back to the Revenue Act of 1942, over 75 years ago.

C. From 1917 through 1942, payments made from one spouse to another for spousal support pursuant to a divorce decree was not taxable as income. See *Gould v. Gould,* 245 U.S. 151 (1917)

D. Now spousal support is treated similarly to child support payments. No deduction to payor; not included as income to the recipient.

E. However, courts still allow spousal support to be deductible by the payor and includible by the payee so long as a divorce decree was entered with the court by December 31, 2018.

1. In other words, if spousal support payments pursuant to a divorce are made after January 1, 2019, so long as the divorce decree was entered with the court by December 31, 2018, those payment arrangements are still validly recognized. In essence, the prior divorce decrees have been "grandfathered."

2. What if the grandfathered divorce decree is modified after January 1, 2019? So long as the parties have not "opted out", modified orders of spousal support still permit the payor to deduct spousal support payments.

3. However, if a modification to a divorce decree occurs after January 1, 2019 and the parties specifically provide that the spousal support payments are NOT deductible by the payor and are not includible in income by the recipient, there will be no deductibility. This is considered an "opt out" provision.

F. When spousal support payments were deductible, in certain situations, such as a higher-earning spouse and a lower earning spouse, those parties were able to transfer income from the higher earning spouse to the lower earning spouse and create a win-win for both parties.

1. Now, the negotiations have become more complex. Why?

2. Psychologically, the payor of spousal support considered the tax deduction to be a benefit. Now the deduction is lost. So what incentives are available for the payor?

3. Consider using property division, which is typically a non-taxable event, in lieu of paying spousal support. Examples:

   a. Transfer a greater amount of retirement assets at pre-tax dollars (assuming a traditional IRA or 401(k)) as part of a property settlement. The benefit is that the recipient pays income tax on the distribution if under 59 ½ but, perhaps, no tax if the distribution is made via a Qualified Domestic Relations Order ("QDRO").

   b. Payors who are business owners may consider contributing considerably more dollars to cash balance or similar plans to replace retirement funds transferred and obtain tax deductions on those contributions.

   c. Transfer funds from investment accounts at pre-capital gains tax rates to the lower earning spouse in lieu of spousal support. Lower earning spouse pays the tax when the equity positions are sold, often at a lower tax rate.

   d. In certain situations involving business or real estate owners, provide in the divorce decree for the lower earning spouse to be given a non-voting, income only interest in the entity in lieu of providing spousal support. This technique may require some revisions to entity documents.

G. The good news for accountants and valuation specialists is that more work is coming your way.

H. There is more of a need to include the participation of the CPA in certain situations, early on, to analyze and evaluate spousal support and consider alternatives.

I. The business valuation specialist may have substantially more work to perform as well.

IV. TIMING ON ENTERING DIVORCE DECREES

A. For tax purposes, the year that the divorce decree is entered determines the marital status of the filers.

B. In many, if not most situations, tax savings are realized when filing jointly than either by filing as single or head of household.

C. If the parties have historically filed their taxes as married filing jointly, they may want to consider having the parties sign the divorce decree in December, 2020, but not filing the divorce decree with the court until early January, 2021 to take advantage of the joint filing status for a final time. The parties may have to negotiate the allocation of the joint tax refunds (federal, state and local) and include the agreed upon allocation terms as part of the divorce decree, especially if the agreement is not a 50/50 sharing of the refund.

V. ADDITIONAL THOUGHTS WORTHY OF MENTION

A. Lower taxes for business owners may result in higher child and spousal support. We are watching.

B. Permanent v. temporary tax law changes in TCJA expire in 2025. But not all.

C. QDROs are extraordinarily important in the divorce process from a negotiating standpoint, given the ability to provide liquidity in a tax favored manner in many cases.

D. The business valuation process in divorces is expected to be impacted by the reduction in business tax rates and in establishing historical trends. Question: Is past financial history still a reliable measure of future expectations of the business, given these tax law changes? Again, looks like more work for CPAs and valuation specialists.