CRAIN'S CUSTOM MEDIA ADVERTISING SECTION

A Roundtable Discussion

FAMILY LAW:

What Divorcing Couples Should Know About Tax Law Changes

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Beginning January 1, changes from the Tax Cuts and Jobs Act of 2017 will start to take effect, including new rules involving tax deductions for divorcing couples. One of the biggest changes involves alimony payments, which will no longer be tax-deductible to payors, or tax-free to recipients.

Three local family law attorneys, including one who is also a CPA, shared their thoughts about the potential impact on divorcing couples, and those contemplating divorce.

ILENE B. GOLDSTEIN is a principal at Katz, Goldstein & Warren, a family law firm based in Bannockburn. She focuses on divorce cases involving complex financial matters, including business and real estate valuation, cash flow analysis and matters involving the parental responsibilities of children and parenting plans. With a career spanning more than three decades, she has been repeatedly recognized by Best Lawyers in America, Illinois Law Bulletin's Leading Lawyers Network, Super Lawyers and Martin Hubble's AV Preeminent Rated Attorneys. She is a certified arbitrator and mediator, and a collaborative fellow with the Collaborative Law Institute of Illinois.

CLAIRE R. MCKENZIE, CPA, is a senior partner at Schiller DuCanto & Fleck LLP, a family law firm with offices in Chicago, Lake Forest and Wheaton. She utilizes her skills in tax planning, financial discovery, forensic accounting, case analysis and litigation to achieve favorable results for her clients. Before law school, she was a tax manager for an international accounting firm and after law school, she was a senior trial attorney for the Internal Revenue Service, U.S. District Counsel. A former chair of the Chicago Bar Association Tax Committee and current Maine Township Trustee, she has been recognized by Best Lawyers, Leading Lawyers and Super Lawyers.

JAMES M. QUIGLEY is a partner at Beermann LLP, which has offices in Chicago and Bannockburn. Over the last 25 years, he has tried complex financial, allocation of parental responsibilities/relocation, maintenance, support and other family law cases involving business valuations, property disputes and prenuptial/postnuptial agreements. He has been recognized repeatedly by Best Lawyers in America and Super Lawyers. He is among four Illinois lawyers elected by the American College of Family Trial Lawyers, a national organization within the American Academy of Matrimonial Lawyers, and he is one of three Illinois attorneys certified by the National Board of Trial Advocacy.

What's the most common question or concern you've been hearing from clients since the tax reform was enacted?

Ilene B. Goldstein: Timing has become a prime question and concern. Clients ask if they should finalize their divorce in 2018 or wait until 2019. The forthcoming statutory changes regarding maintenance will have a more disparate impact on families with a higher-income earner because individuals in higher tax brackets will no longer have the ability to transfer income to their spouse in the lower tax bracket via maintenance, thus lowering the overall amount of tax paid by both spouses.

Claire R. McKenzie: We hear questions focusing on settlement agreements. Clients are asking, "Do I need to get divorced by December 31 to get the best settlement or maintenance award possible?" "Does the new tax reform and repeal of the alimony deduction really matter?" "Isn't it just math?"

James M. Quigley: Clients want to know whether they'll be able to shift maintenance payments from a higher income tax bracket of the paying spouse to the lower income tax bracket of the receiving spouse in a way that would minimize the overall tax liability of the family. Former clients also want to know whether the new tax law will impact the deductibility of their existing maintenance obligation and whether they'll continue to pay tax deductible maintenance if the obligation is modified or extended in the future. Statutory language suggests that future modifications to maintenance awards originally entered prior to January 1, 2019 will remain deductible unless the parties elect otherwise.

How would you describe the overall impact of the tax reform on divorce?

JQ: The greatest impact is in the area of maintenance. Historically, maintenance deductions have been used by families to minimize the overall tax obligation for both parties, resulting in more available net income to be divided amongst the two households and less tax being paid to the government. The new tax law has done away with this shifting of income, so that all support obligations–maintenance and child support–are paid after being taxed to the person who earned that income. Also, the advantage of unallocated support, which combines child support with maintenance, has been eliminated and therefore is no longer deductible. With the elimination of the deductibility of maintenance, unallocated support has been eviscerated as well.

CM: Combine the complexity of the tax law changes with the changes a party must face and address while going through a divorce and my response is simply, "It is likely going to be more challenging to reach settlements in the short term and until the entire family law community is comfortable with the new tax law." Now, it is even more important for individuals contemplating or navigating through the divorce process to seek the advice of a knowledgeable family law attorney and at the same time engage the necessary outside professionals to assist them to achieve their ultimate goals both financially and for their family.

IBG: While not unique to divorce, it makes it more difficult to creatively reduce a party's taxable income while achieving a net result that's better for both parties. The changes brought about by the tax reform act impact settlement negotiations, thus making divorce cases more complicated. Lawyers frequently use divorce software when trying to analyze the tax impact of various settlement scenarios; however, it's important to remember that some of the software used to calculate these tax implications–especially as it relates to alimony and child support–have not been updated to conform with the changes brought about by the tax reform act, so people should proceed with caution.

What's the new process for calculating maintenance for those subject to Illinois guideline rules?

CM: Since 2015, Illinois has maintained guideline provisions that continue to be clarified and modified. Beginning January 1, maintenance will be calculated by taking 33.3 percent of the payor's net–rather than gross–income, minus 25 percent of the payee's net income.

IBG: The amount of maintenance is capped so that the recipient's own net income combined with the maintenance amount received cannot exceed 40 percent of the parties' combined net incomes. Current statutes are in the process of being implemented by the legislature to conform with the new tax laws.

IMPACT ON HIGH-NET-WORTH INDIVIDUALS

"The most significant aspect affecting high-net-worth individuals is the elimination of the tax deductibility of maintenance, where historically a high-income wage earner would be able to shift income tax at the highest bracket to the divorcing spouse in the lower tax bracket."

JAMES M. QUIGLEY, BEERMANN LLP

JQ: Section 505 of the Illinois Marriage and Dissolution of Marriage Act outlines a formula to calculate maintenance, though there appears to be discretion for the court to deviate from the formula where the guidelines would result in the payor paying 50 percent or more of his or her net income for maintenance and child support.

What effect does it have on dependency exemptions and the child tax credit?

JQ: The new tax law eliminates individual dependency exemptions until 2026.

IBG: While it eliminates dependency exemptions, it increases the child tax credit from $1,000 to $2,000 on each qualifying child younger than age 17. A tax credit offsets the taxes owed dollar for dollar. This will impact negotiations on child tax credits, as couples will argue over who'll be entitled to take each child's tax credit. The income levels at which the child tax credit is phased is now higher at $400,000 for married jointly and $200,000 for all other filers. Fifty dollars in child tax credit is phased out for every $1,000 of adjusted gross income above the stated limits. There may also be a $500 credit available for dependents who are not under age 17 children, but whom qualify for the child credit.

CM: To claim the child tax credit, you must have a child younger than age 17 at the end of

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"It's imperative for us to work collaboratively with clients' accountants and financial professionals to ensure that everyone's on the same page regarding short- and long-term financial goals . . . support obligations, which assets are being received by each party, and tax implications of divorce-related decisions should all be discussed."

ILENE B. GOLDSTEIN, KATZ, GOLDSTEIN & WARREN

the year and that child had to have lived with you for at least one-half of the year. However, as was the case previously, you can only claim the child tax credit if you are entitled to claim the child as a dependent. So, for income tax purposes, it is important to negotiate the allocation of the dependency exemptions or who is entitled to claim any of the children as dependents.

What aspects of the new tax reform especially affect high-net-worth individuals going through a divorce?

JQ: The most significant aspect affecting high-net-worth individuals is the elimination of the tax deductibility of maintenance, where historically a high-income wage earner would be able to shift income tax at the highest bracket to the divorcing spouse in the lower tax bracket, thus minimizing the overall tax paid by the family. With limitations on the deductibility of property taxes, higher-net-worth individuals are likely to pay more tax and as a result, will have less net income. That potentially will reduce their net income for purposes of calculating maintenance, thus resulting in lower maintenance awards. Obviously, this can't be viewed in a vacuum as there are many other tax provisions in play, including those for divorcing parties who own businesses. Additionally, the individual tax brackets will dictate the plus or minus effect on divorcing spouses.

CM: Another issue is premarital agreements, which high-net-worth individuals are more likely to have. These agreements may need to be reviewed with a financial advisor and the family law attorney who drafted the document to make sure that none of the new tax laws negatively affect the goals of the agreement. The sweeping changes of the new tax law were intended to benefit low- and middle-income Americans at the expense of high-net-worth, high-income Americans, and it accomplished its goal. Although the marginal tax rate to high earners didn't increase, the elimination or restriction of tax deductions negatively impact their effective tax rate. Unfortunately, this includes those individuals going through a divorce.

IBG: Many divorcing parties have interests in closely held businesses that need to be valued for purposes of divorce. The lowering of the federal corporate tax rates could result in higher business valuations for closely held businesses. Having a larger percentage of a divorcing couple's net worth as illiquid can make negotiation of property settlement agreements even more challenging.

How do you and your colleagues work with your divorce clients' other advisors?

IBG: In light of recent tax law and statutory changes, it's imperative for us to work collaboratively with clients' accountants and financial professionals to ensure that everyone's on the same page regarding short- and long-term financial goals. Considerations such as support obligations, which assets are being received by each party, and tax implications of divorce-related decisions should all be discussed. Other topics include calculation of income–taking into consideration business deductions–capital gains taxes, real estate tax deductions, child care credits, value of investments, timing of divorce, future earning capacity, business valuation and retirement.

JQ: We have clients' financial advisors and CPAs run hypothetical projections and pro forma tax returns to understand the different scenarios to ascertain the most tax advantageous and cost-effective resolution. We also work with our clients' advisors to ascertain basis points on assets such as stock portfolios and real estate to determine which assets to shift to the other party in a way that's most advantageous and beneficial to our clients.

CM: We may work with the client's financial advisor to establish the individual's marital lifestyle, household and personal needs as well as the amount and configuration of the property settlement needed to support their post-divorce lifestyle. We may also work with a vocational expert to help the client determine how to become self-supporting. Often times we engage the client's financial advisor or planner to determine how a client can structure a property settlement or buyout of a spouse to achieve both parties' goals and objectives.

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FOR THOSE CONSIDERING DIVORCE

"In 2018, if you're contemplating a divorce, run—do not walk—to consult with a knowledgeable and tax-savvy family law attorney to explore all options, planning opportunities and alternative strategies to choose which options are best for you and your family."

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A client's life coach or therapist may assist us in making sure they have and maintain the support system needed to navigate this arduous and contentious process. All of these advisors assist us and the clients in understanding their alternatives and achieving their goals–economic and otherwise. The advisors are invaluable to both the clients and to us.

What will be the impact on divorces finalized before year-end 2018?

IBG: Finalizing by December 31 will allow divorcing spouses to elect whether to have maintenance calculated and paid on each party's gross or net income. Finalizing a divorce by year-end may be advantageous to both spouses as the deductibility of maintenance may result in more funds being available to both parties.

JQ: Finalizing prior to December 31 means parties can't take advantage of the often-used strategy of delaying until the new year to take advantage of joint tax filing. However, if they do delay until 2019, those families with a high wage earner shifting maintenance to a divorcing spouse in a lower tax bracket will lose the ability to minimize the overall tax being paid through deductible maintenance. It's imperative for divorcing individuals to consult a divorce attorney and a CPA to analyze which scenario is the most beneficial.

CM: Alimony or maintenance will still be deductible for the payor and the recipient must include the alimony or maintenance received in their taxable income as long as they continue to receive it. Even if the maintenance terms in an agreement entered on or before year-end are later modified, the alimony or maintenance paid remains tax-deductible by the payor and included in income by the payee. In those cases, parties must still be mindful of the alimony recapture rules associated with deductible maintenance awards; individuals should consult an attorney for more details.

In light of the new tax reform, what advice to you have for individuals contemplating a divorce?

CM: Normally, I'd never suggest rushing to a family law specialist for divorce consulting. But in 2018, if you're contemplating a divorce, run–do not walk–to consult with a knowledgeable and tax-savvy family law attorney to explore all options, planning opportunities and alternative strategies to choose which options are best for you and your family. The expiring deduction for alimony could have a significant financial impact on many families. Clearly, divorce is not a one-size-fits-all model. It is important to understand what's best and most advantageous to you and your family, before you begin the divorce process, settlement negotiations, mediation or collaborative divorce meetings.

IBG: Individuals contemplating a divorce should collaborate with their attorney, financial advisors and tax accountant to ensure that the maximum tax benefit is achieved. I'd also encourage individuals with existing divorce-related agreements to take a close look at theirs to determine whether changes in the tax laws impact the intent of their agreement. For example, a prenuptial agreement may include a maintenance formula based on the presumption that maintenance would be taxable in the event of divorce. Since maintenance will no longer be deductible as of 2019, the prenuptial agreement may be impacted. Further, many divorce judgments negotiated before the tax law changes included the ability to claim exemptions which have been eliminated or devalued. While courts won't modify any prior judgments or agreements based on the change in the tax law or statute alone, if a party can demonstrate other substantial changes in circumstances, there may be a basis to modify existing agreements to a client's benefit.

JQ: Maintenance, as well as unallocated support, are concepts that should be contemplated immediately before the benefit is lost at the end of this year. We also advise clients to immediately consult with trusted advisors such as wealth advisors, CPAs and others to develop a strategy designed to maximize the benefits of the new tax law and/or avoid any detriments of the new tax law that may have an impact on the overall financial effect of the divorce.

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