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Different ways to reduce sting after loss of the maintenance deduction

It has been a year since the new alimony (commonly referred to as maintenance in Illinois) laws became effective following the Tax Cuts and Jobs Act's passage and signing into law. Needless to say, the act substantially altered the Internal Revenue Code.

Among the changes was the repeal of Sections 71 and 215 of the Internal Revenue Code, which generally provided that maintenance was an above-the-line deduction for the payor spouse and taxable income for the recipient spouse.

However, with the act's passage, maintenance payments made pursuant to a divorce or separation instrument is executed after Dec. 31, 2018, or modified after that date that includes specific language that the act's treatment of maintenance payments applies, is no longer an above-the-line deduction for the payor spouse and is no longer taxable income to the recipient spouse. In sum, maintenance is no longer a deduction.

In light of the new tax law, Illinois amended Section 504 of the Illinois Marriage and Dissolution of Marriage Act such that maintenance is calculated using the parties' net incomes.

Specifically, Section 504 (b-1)(1)(A) provides that maintenance is calculated by taking 33.3% of "the payor's net annual income minus 25% of the payee's net annual income. The amount calculated as maintenance, however, when added to the net income of the payee, shall not result in the payee receiving an amount that is in excess of 40% of the combined net income of the parties."

Like the Tax Cuts and Jobs Act, the calculation as set forth in Section 504(b-1)(1)(A) only applies to those separation instruments executed after Dec. 31, 2018, and does not necessarily apply to those instruments executed prior to Dec. 31, 2018, including the modification of those instruments.

Section 504(b-1)(1)(A-1) provides that modifications of separation instruments executed prior to Dec. 31, 2018, may be eligible for inclusion in the taxable income of the recipient spouse and deductible by the payor spouse, as long as the time-honored list of specific tax law requirements are met.

MODERN FAMILY

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The practical consequence of the new law is that unfortunately the loss of the arbitrage of tax rates between payor and payee leaves less cash to allocate between two spouses, adding an extra layer of complication to settlement negotiations. This has required divorce attorneys and financial planners to become more creative in structuring a divorce or separation instrument.

When dividing marital property, spouses may intuitively think that they want 50% of all assets. However, this is not always the best approach from a tax savings perspective, and the tax consequences should be taken into consideration when dividing the marital estate.

There are many different types of creative strategies that can be employed that could help spouses pay less to Uncle Sam and keep more in the marital estate.

First, the spouses could choose to "pay maintenance" by transferring retirement accounts that were funded with pretax dollars to the recipient spouse. This would effectively allow the payor spouse to "pay maintenance" without paying any tax on the money and shifting the tax liability to the recipient spouse.

This approach can also be advantageous for the recipient spouse because even though the recipient spouse would have to pay tax on the money when it is withdrawn, the recipient spouse gets the benefit of a larger fund to draw income from.

Of course, before choosing to employ this approach, it is important to confirm that the recipient spouse will not be subject to an early withdrawal penalty, meaning that the recipient spouse is at least 59½ years old

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when the funds are withdrawn, or a qualified domestic relations order is drafted in such a way that would allow the non-employee spouse (or alternate payee) immediate access to the funds without becoming subject to the early withdrawal penalty.

Spouses could also choose to transfer property, such as stocks, mutual funds or real estate, in lieu of maintenance, an option that is regularly endorsed by courts as it provides a cleaner break between the spouses than a continuing obligation to pay maintenance.

Under the 2019 tax rates, single taxpayers can have up to $39,475 of taxable income and not pay any federal capital gains tax. This would mean that the recipient spouse with no taxable income could sell a capital asset with a gain of $39,000 and not have to pay any taxes on the gain.

On the other hand, the payor spouse almost undoubtedly in a higher tax bracket would likely have to pay capital gains tax on sale of that same capital asset. As a result, spouses with a large investment portfolio could retain more funds in the marital estate by transferring capital assets with high capital gains to the lower income spouse.

If the idea of paying a lump sum of maintenance is attractive to spouses, but cash does not exist to make the lump sum payment possible and it would be necessary to sell assets, spouses can choose to utilize a new program that comes with the passage of the Tax Cuts and Jobs Act — opportunity zone investing.

Under this program, spouses have the ability to sell appreciated property and invest the realized gain in qualified opportunity zone properties, or an "economically distressed community" as defined by the IRS, thereby deferring and possibly reducing the tax liability associated with the sale of the asset.

Although this option does not completely mitigate the tax liability associated with the sale of the asset, it can be used as a creative option to provide cash for the payment of maintenance while at the same time reducing the taxable income for the payor spouse.

Although the Tax Cuts and Jobs Act includes a sunset provision, the elimination of the maintenance deduction is permanent unless and until Congress decides to enact new legislation.

Savvy spouses (and lawyers) can negotiate a win-win by utilizing creative solutions to keep more assets in the marital estate and less out of the hands of the IRS.

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