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FAMILY LAW

New Federal Law Makes the Practice of Family Law More Taxing

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On Dec. 21, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017 (TCJA) into law. Although most media outlets have focused primarily on the new tax brackets, the new corporate tax rate and other aspects of TCJA that are convenient for headlines, TCJA implemented other less-publicized changes that will significantly affect family law matters in the future. It is imperative that all attorneys practicing in this area of the law become familiar with the changes, as they go right to the core of many issues that are faced on a day-to-day basis.

Among the family law areas most affected by TCJA are the treatment of alimony, personal exemptions, standard deduction and child tax credits, home mortgage and home equity loan interest, limitations on the state and local tax deduction, and increases in the estate and gift tax exemptions. Additionally, in those cases where a prenuptial agreement was entered into prior to TCJA, provisions in those agreements (e.g., alimony payments) may be affected or even rendered unenforceable by the new law, depending on the timing of a future divorce.

The most important change in the law affecting divorcing parties is the elimination of the tax deduction for alimony paid. Prior to TCJA, alimony and separate maintenance payments were deductible by the payor spouse under Section 251(a) and includible in taxable income by the recipient spouse under Sections 61(a)(8) and 71(a) of the Internal Revenue Code. As a result of TCJA, alimony payments required under a settlement agreement or judgment of divorce executed after Dec. 31, 2018, will no longer be deductible by the payor or taxable to the payee.

Example: Assume that one spouse is a high-earner and she is obligated to pay alimony to the former spouse in the amount of $50,000 per year pursuant to a property settlement agreement entered into in January 2017. The payor spouse is in the 39.6 percent bracket, and the recipient spouse is in the 25 percent bracket. The deduction saves the payor spouse $19,800, and the recipient spouse has an additional tax of $12,500. This results in

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a net aggregate savings of $7,300. Under the new law, for agreements after 2018, since the payor spouse is not entitled to a deduction, those savings will disappear. The loss of the tax savings previously available as a result of the payor spouse's deduction at a higher rate effectively means that there is less collective after-tax money to be used for the support of both parties and, therefore, less income available to the payor for support of the payee.

Since alimony has been taxable to the payee and tax-deductible to the payor for as long as any currently practicing attorney can remember, family law practitioners (and judges) have been trained to focus on each party's before-tax income when assessing the ability of the supported spouse to contribute to his or her own support, and that of the supporting spouse to contribute to the support of the other. Since alimony will no longer be taxable to the recipient or tax-deductible to the payor, practitioners will now need to shift their focus to the parties' respective after-tax incomes in order to determine the appropriate amount of alimony to be agreed upon or ordered. This will likely create far greater scrutiny on the accuracy of the parties' respective analyses of their own after-tax incomes.

Another interesting consequence of TCJA is that the Child Support Guideline calculations will yield different results based upon the reduction in federal tax rates and the change in the tax treatment of alimony between the respective parties. These changes are likely to change the total net income available for consideration under the Child Support Guidelines.

The changes to the tax treatment of alimony under TCJA only apply with respect to any divorce or separation instrument (as defined by Section 71(b)(2) prior to its repeal) executed after Dec. 31, 2018. Thus, implementation of the repeal is delayed for one year. Divorce and separation agreements executed on or before the law's Dec. 31, 2018, effective date will be grandfathered. Grandfathered agreements modified after the Dec. 31, 2018, effective date will also be grandfathered, unless the modification expressly provides that the modified agreement shall be governed by the new law.

While that sounds clear enough at first blush, what happens with respect to a prenuptial agreement executed prior to TCJA, which required the payment of alimony in the event of a termination of the marriage? For example, assume that in 2016 a couple married and, pursuant to a prenuptial agreement between the parties, one spouse was required to pay a fixed tax-deductible alimony amount to the other spouse in the event of divorce, and the parties divorce in 2019. Despite the parties' intention in 2016, will that alimony payment be deductible by the payor and taxable to the recipient spouse in 2019? The new alimony provisions under TCJA are effective for any divorce or separation instrument (as defined in Code Sec. 71(b)(2) as in effect before Dec. 22, 2017) that is:

> (i) executed after Dec. 31, 2018 (2017 Tax Cuts and Jobs Act §11051(c)(1)), or
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> (ii) executed on or before Dec. 31, 2018, and modified after Dec. 31, 2018, if the modification expressly provides that the amendments made under 2017 Tax Cuts and Jobs Act §11051 above (i.e., repealing the alimony deduction, and the inclusion of alimony in gross income) apply to the modification.

While an open issue remains with respect to the treatment of a prenuptial agreement entered prior to TCJA, when a divorce occurs after Dec. 31, 2018, the likelihood is that the prenuptial agreement will not be considered a "divorce or separation instrument," and the payments will likely be considered nondeductible to the payor and nontaxable to the recipient. Consider revisiting older prenuptial agreements with clients prior to Dec. 31, 2018, to determine the extent to which a party may have a greater obligation once the tax benefits of the deduction for alimony are removed.

One of the other significant changes effected by TCJA is the tax treatment of pass-through income from a business. Effective for tax years after Dec. 31, 2017, qualified business income that passes through to an individual from a pass-through entity (e.g., partnerships, limited liability companies, etc.) and income attributable to a sole proprietorship will be taxed at individual tax rates less a deduction of up to 20 percent. This change will significantly reduce the tax rate on such income. The law regarding the tax treatment of pass-through qualified business income is quite complicated, and is rife for manipulation by creative tax professionals. This means that in negotiating support payments, complex analysis will be required to determine the net after-tax income of the payor spouse. This will likely result in the need for each party to seek the advice of tax experts during the negotiation of any alimony award, thus potentially significantly increasing the costs associated with any divorce.

The taxability of unallocated support has always been a huge issue in divorce matters. However, now that neither alimony nor child support payments are deductible by the payor or includible by the payee, does this issue simply go away? Will there be a return to orders of unallocated support? Maybe, but keep in mind that notwithstanding the change in the taxability of alimony at the federal level, New Jersey has not changed its law. Thus, alimony will still be deductible by the payor and includible by the payee for New Jersey income tax purposes. This difference between the federal law and New Jersey law, and its impact on each party's total after-tax income, will play an important role in future alimony negotiations.

Then there is the issue of settlement agreements executed prior to the effective date of TCJA, which include bargained-for provisions that no longer are enforceable. It was previously commonplace for divorcing parties to negotiate which of them would claim the children as exemptions on their individual tax returns, or in what fashion the parties might divide or alternate the exemption entitlements. As a result of TCJA, all personal exemptions have been eliminated (in exchange for a near doubling of the standard deduction). Consequently, many parties to previously executed settlement agreements will find they are no longer able to claim a benefit that they specifically bargained for, while other parties will effectively receive a windfall.

Consider the scenario of an ex-husband who agreed to allow his ex-wife to claim each of their four children as exemptions in exchange for accepting a lesser amount of child support than the ex-husband otherwise would have paid. That arrangement may have been equitable prior to the passage of TCJA, but now that the ex-wife can no longer claim the children as exemptions, she loses the resulting tax savings ($4,050 per child as of 2017) while still receiving the lesser amount of child support from the ex-husband. Will this disruption to the quid pro quo of settlement agreements constitute a change of circumstances warranting a modification of child support and/or other aspects of the settlement agreement? Only time will tell.

While there will certainly be other issues that arise as a result of the significant changes to the federal tax law under TCJA, we have tried to focus on those that will present the most common challenges. Nonetheless, this article is hardly an expansive explanation of the issues that are bound to arise. Therefore, it is important for all family law practitioners to be able to identify and address these tax issues in order to properly represent their clients. ■