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New tax law will turn divorce, maintenance matters topsy-turvy

Family law issues are governed by the Illinois Marriage and Dissolution of Marriage Act. Federal law, however, plays a significant role in all divorce proceedings through the Internal Revenue Code.

On Dec. 20, Congress successfully passed the Tax Cuts and Jobs Act of 2017. There is no doubt the act will heavily impact all individuals and business entities in a variety of ways, but unfortunately, this tax reform will be particularly burdensome to couples going through a divorce after this year.

Divorcing couples have no choice but to embrace the drastic repercussions that this new act will have on the tax treatment of maintenance and how it impacts their families' financial situations.

Before the changes

Maintenance, formerly known as alimony, has historically been deductible for the obligor and includible as income for the obligee.

Allowing the payor spouse to deduct maintenance from their taxable income essentially reduces after-tax cost of maintenance for the payor spouse. The payee spouse typically pays less income tax to the government than the payor saved resulting in a lower amount of taxes the family pays overall.

This has allowed many couples to walk away from the divorce process somewhat satisfied and keeping more money in each of their pockets.

After the changes

After the changes go into effect, judges still need to first decide whether an award of maintenance is even appropriate for divorcing spouses.

Then, if an award of maintenance is found to be appropriate, for couples that enter into divorce agreements or judgments after Dec. 31 of this year, maintenance will no longer be considered income to the recipient spouse for federal tax purposes. In turn,

maintenance payments will not be tax-deductible.

Who's affected?

The changes to our tax structure through the act apply to any settlement agreements or judgments entered into between divorcing spouses on or after Jan. 1 of next year.

All agreements and judgments, including modifications of these actions, that are entered on or prior to Dec. 31 are somewhat immune from this radical tax reform. If for some reason the parties do not want any modifications to the agreements they entered into on or before Dec. 31 to remain includible and deductible for tax purposes, the parties must expressly provide for that in their modified agreement or else the old tax law will apply.

Effects of the act

The tax structure for maintenance payments will parallel child support payments. One reason expressed by the government in support of implementing a similar tax structure for maintenance is that under the current tax structure, members of divorced families are supposedly receiving better tax benefits than they would have had they stayed married.

... it will be interesting to see how many more couples that can afford a lump sum settlement choose to take it without the tax incentive to pay over time.

The act will likely have a negative impact on settlement negotiations between divorcing spouses. The tax deductibility for the payor spouse and the ability of the recipient spouse to claim maintenance as taxable income has historically been a very important factor considered by courts and parties when calculating and negotiating maintenance obligations.

The elimination of the tax deduction will also take away several negotiating options for couples.

COLLABORATIVE CONCEPTS



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The payor spouse will propose a lesser amount of maintenance to be paid to the recipient spouse because the recipient spouse is guaranteed a tax-free support payment.

The full long-term impact of this drastic change is still unknown. Heather L. Locus, a CPA, wonders if some recipient spouses will lose the ability to contribute to individual retirement accounts.

"Having taxable maintenance qualifies as the earned income required to make an IRA contribution and the ability to contribute to a retirement account is very empowering to a lot of recipient spouses, Locus said.

for the child tax credit and other tax benefits going forward.

Maintenance laws as set forth in the Illinois Marriage and Dissolution of Marriage Act assume deductibility based upon gross income. For this reason, Locus believes it is likely that changes to the marriage act will be necessary to better coincide and adapt to the consequences of the Tax Cuts and Jobs Act of 2017 in a short while.

Businesses

Businesses will feel the effects of the act in several ways. There is now a flat 21 percent corporate tax rate, which will increase the value of businesses by default. No matter what evaluation method is used, when parties are valuing a business in a divorce proceeding, the business will be worth more than it was prior to the tax changes.

Prenuptial and postnuptial agreements

Immunity from this tax reform does not apply to couples who have entered prenuptial or postnuptial agreements on or before Dec. 31. Any prenuptial and postnuptial agreements entered between couples while under the assumption that tax deductions would exist with maintenance will most likely need to be re-evaluated to better reflect the changes in the new law. Practitioners have to seriously consider sending those past clients information regarding this significant change.

Going forward

Family law attorneys and divorcing couples must be aware of these tax changes and how this reform will change the divorce process moving forward. There are less than 300 days left until the landscape of maintenance is completely changed. Needless to say, divorce practitioners should have a very busy finish to 2018.

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