Accountants and Divorce Attorneys: A Marriage Made in Congress

As divorce attorneys seek to navigate the impact of the Tax Cuts and Jobs Act ("TCJA") on divorce cases, one thing appears clear: Effective advocacy for matrimonial clients will require greater reliance on accounting professionals. Beyond the repeal of taxable or deductible alimony, the TCJA's elimination of personal exemptions and increase in child tax credit, the limitation on "SALT" deductions, the new Qualified Business Income Deduction ("QBID"), and the expanded use of 529 Plans will all present new tax issues for the divorce practitioner to consider. It will therefore be imperative for attorneys to obtain an accountant's input to assess how these individual tax reforms will impact the economic future of a matrimonial client. Assistance from valuation experts will also be crucial as we tackle the impact of the TCJA's sweeping corporate tax reforms on business valuations.

New Tax Law, Applied to an "Old" Maintenance Formula

In June 2015, after years of effort and with the input of various competing interest groups, the New York legislature passed what is known as the Maintenance Guidelines Law. This law, which became effective for cases commenced on or after Jan. 25, 2016, established for the first time that a formula shall be utilized to determine final awards of spousal maintenance (i.e., alimony) in New York. The formula is based on the parties' respective incomes, with the payor's income being capped at the (current) amount of $184,000. The maximum amount of guideline maintenance produced by the formula is $55,200 per year, or $4,600 per month. This occurs in cases where no child support is being paid by the maintenance payor, where the payor's income is $184,000 or more, and the payee's income is $0. (The official worksheet for calculating the guideline maintenance amount can be found here.) As discussed below, the court has the discretion to deviate from the guidelines by, for example, awarding additional maintenance beyond the guideline amount based on the application of statutory "deviation" factors.

The Maintenance Guidelines were drafted and enacted in 2015, when alimony payments were taxable to the recipient and deductible to the payor. Thus, the mathematical formulas for determining the presumptive guideline maintenance payment were crafted with the recognition of such tax treatment. In other words, when the drafters of the legislation wrangled with the creation of the formulas, they contemplated that the amounts to be received and paid would be taxed on the one hand and tax-deductible on the other. The TCJA, however, repealed IRC sections 71 and 215, which made "alimony or separate maintenance payments" includible as gross income. Commencing with "divorce or separation instruments" executed after Dec. 31, 2018, alimony will not be taxable to the recipient nor tax-deductible to the payor.

Considering the long and difficult process that was required to achieve spousal maintenance reform in New York at the legislative level, it is probably safe to assume that the Maintenance Guidelines will remain the law for determining spousal maintenance for the foreseeable future. It will therefore be essential in certain cases to advocate for the factors set forth in New York's Domestic Relations Law section 236(B)(6)(d), which provide the court with flexibility to deviate from the presumptive guideline maintenance amount where appropriate.

In particular, the statute provides that the court may consider "the tax consequences to each party" when determining whether to deviate from the guideline amount. The best way to present persuasive evidence in support of this factor will require input from an accountant, who can prepare a comparative income and cash flow analysis in order to highlight the impact of all applicable aspects of the TCJA. The accountant could provide a comprehensive analysis, which includes and accounts for the new rates, the increase in the standard deduction, the potential availability of the new QBID, the cap on "SALT" deductions, and the increase in the child tax credit, among other things. In addition to presenting the anticipated post-divorce net cash flow, a comparison between the "old" law and the "new" law can also be shown in order to demonstrate why deviation from the formula is or is not appropriate.

Divorce attorneys will also need to re-think the economics of a settlement. The tax treatment of spousal maintenance has long served as a valuable settlement tool for divorce practitioners. By essentially shifting income from the higher tax payor to the lower tax payor with payments of taxable maintenance, divorcing spouses have been able to take advantage of what was essentially an IRS-approved "divorce subsidy." Commencing in 2019, the divorce subsidy is gone, and the alimony calculated under the Maintenance Guidelines will now be paid on a tax-free basis. A post-settlement cash-flow analysis from an accountant that factors in all aspects of the TCJA under a proposed settlement could be a valuable negotiation tool.

Modifications of Existing Maintenance Obligations

The new tax treatment of alimony under the TCJA will apply to modifications of pre-2019 maintenance orders and agreements *only if* the modification expressly provides that the new tax law shall apply. If the modification instrument does not specify that the new tax law applies, then the maintenance will continue to be governed by pre-TCJA tax law. Accordingly, any application to the court for modification of a maintenance obligation should provide an analysis of the tax implications of the modification in order to effectively present arguments for or against TCJA treatment. Again, a holistic analysis, prepared by an accounting professional, should be presented to the court in support of the client's particular position.

One argument in favor of applying the same pre-TCJA tax treatment to a subsequent modification could be that the parties or the court specifically contemplated such tax treatment when fashioning the original maintenance award. It might very well be the case, however, that taxable maintenance is no longer appropriate in light of the several other changes to individual taxation contained in the TCJA that impact an individual's net cash flow.

Living Under Two Separate Tax Schemes

Unless expressly modified so as to apply the new tax treatment provided under the TCJA, existing maintenance orders or agreements will continue to be governed by pre-TCJA tax law. Yet the TCJA contains several changes to individual taxation beyond the repeal of taxable/deductible alimony that are likely to impact divorced parties' overall tax situation. Therefore, many former spouses will continue to have their maintenance obligation or payment governed by one tax scheme, while their overall tax situation might be fundamentally altered under the TCJA's other reforms that became effective commencing in 2018.

Such changes could significantly impact post-divorce cash flow for parties who might have relied upon the expectation that the pre-2018 tax law would continue when they negotiated their settlement. For example, one can envision a scenario where a settlement agreement has been entered into under the assumption that real estate and New York State income taxes will be fully deductible, substantially reducing if not eliminating the taxable income of a maintenance recipient. Under the TCJA, the maintenance income under this pre-2019 agreement will nonetheless continue to be taxable to the recipient, but the deductions for his or her real estate taxes and New York State taxes are now capped at $10,000 per year. Meanwhile, depending on the particular sources of income of the support payor, the TCJA might result in a significant increase in his or her net after-tax income, resulting in a fundamental alteration of the economic balance of the settlement. Similarly, parties might have negotiated the allocation of the dependency exemptions and how future college expenses would be paid, but the TCJA has altered the rules applicable to those issues as well.

Accordingly, in assessing whether a support modification motion might be warranted, it will be important for divorce attorneys to obtain analyses from a tax professional to determine the full impact of all aspects of the TCJA on each party's net income.

Business Valuation Issues

The TCJA will also impact future business income and thus valuation. For example, effective 2018, the federal corporate tax rate has been permanently reduced from a high of 35% to a flat rate of 21%; corporate interest expense deductions will be limited in certain cases, potentially resulting in an increased cost in capital; entertainment expense deductions have been eliminated; and amendments to the rules for IRC section 179 deductions and bonus depreciation could result in higher cash flow in the short term.

The impact of these reforms on business valuations will need to be assessed on a case-by-case basis—particularly for pending cases with pre-2018 valuation dates, divorce attorneys must now consider questions concerning the appropriate valuation date and valuation methodology, whether the expert may consider the "subsequent event" of the change in tax law, and whether they should choose our own expert rather than using a neutral one. For cases commenced prior to the TCJA but tried or settled thereafter, it might be appropriate to ascertain whether a current valuation date would be more advantageous than a commencement date valuation. Of course, there is no guarantee that consideration of the TCJA will automatically result in a more advantageous valuation, so attorneys must proceed with caution, seeking the expert input. Similarly, attorneys will rely upon valuation experts in determining whether the particular valuation method employed has properly accounted for the TCJA's impact.

In Sum

While the full extent of the TCJA's impact on divorce cases remains to be seen, it is clear that effective divorce attorneys must perform a thoughtful analysis with assistance from accounting professionals.

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