Should You Get a Divorce Now or Later?

By Paul Sullivan

July 27, 2018

Lawyers and accountants often push their clients to plan for unpleasant events. Better to be prepared now than to pay the consequences later. But the Republican tax law that took effect in January has added a new urgency for wealthy Americans contemplating divorce.

Several key changes in the law may determine whether it is better to complete or update a divorce agreement by Dec. 31 or wait until the new year.

One of the biggest changes affects alimony, which will not be a tax break for Americans whose divorce agreements are completed or updated after this year. The new tax law is also causing parting spouses to look more closely at benefits for their children and the values of privately owned businesses and partnerships.

There is a lot of money at stake for wealthy couples. Nearly 600,000 taxpayers claimed alimony deductions totaling more than $10 billion for the 2010 tax year, according to the Internal Revenue Service.

Here are four areas that couples considering a divorce should examine before the end of the year:

Alimony

When it comes to alimony, the tax law is going to turn the calendar back 77 years. That was when the Revenue Act of 1942 first made alimony deductible for the spouse paying it and taxable for the spouse receiving it.

The deduction was granted to help couples make the transition from being joint taxpayers to paying separately, said Suzanne L. Shier, chief tax and wealth planning strategist at Northern Trust.

But the arrangement has led in recent years to underreporting alimony payments. The last estimate from the I.R.S. showed that almost half of recipients paid no tax on alimony or paid tax on an amount that was less than what the former spouse claimed as a deduction, Ms. Shier said.

In other words, ex-spouses could be overstating the alimony they paid to increase their deductions, or ex-spouses receiving alimony could be understating the amount. Or both.

The tax change could become problematic in divorces settled after Dec. 31 because one spouse will lose a tax benefit and the other will gain one. Under the new system, the alimony payer will be taxed on the full amount while the recipient will pay no tax on it.

“When you’re trying to resolve cases, that ability to get a tax benefit has been very useful,” Judith L. Poller, a partner and co-chairwoman of the family law group at Pryor Cashman.

A simple solution for couples negotiating a divorce, and expecting an alimony payment, is to complete the agreement by the end of the year to preserve the deduction. But this could be easier said than done in an acrimonious divorce.

Prenuptial Agreements

For couples who drew up prenuptial agreements, the outcome should they divorce is more uncertain. It is common in prenuptial documents for lawyers to insert language calculating alimony payments based on years of marriage and a clause saying alimony payments are deductible for one spouse.

Jeffrey Cohen, a divorce lawyer at Cohen Goldstein, said he was not sure whether these clauses would hold up in 2019 and beyond.

“You have a written contract on the one hand, but people say, ‘I wouldn’t rely on it,’” he said.

In the absence of guidance from the I.R.S., Ms. Poller said a document providing for deductible alimony might not be honored if alimony was no longer deductible. A married couple might want to consider renegotiating the agreement before the end of the year, even if it might unsettle the marriage.

Business Valuation

But there are reasons to delay a parting of ways. Other tax-driven divorce issues require a more careful eye.

One is how private businesses should be valued. This has always been an important component of divorce settlements. But the new tax law increases the cash flow of certain pass-through entities — businesses where the taxes on the earnings are paid by the owner, not the company — in a way that raises their value.

“Because of increased cash flow and reduced taxes, my business could have gone from a value of $6 million to $9 million,” Mr. Cohen said. “Whoever wants the money will get more, and whoever has the money will have more to give.”

Figuring this out will require more valuation experts, increasing the cost and time it might take to get a divorce.

A business is almost always the most contested asset in a divorce, with a lot of the numbers in a settlement derived from its value, said Neena Tankha, a partner in the matrimonial and family

law practice at Warshaw Burstein.

One of those numbers is child support, which she said was generally negotiated only once, with a provision made for inflation-adjusted increases. This raises the importance of getting the value right.

“We might think that business might have a higher valuation, but what does that mean?” Ms. Tankha said. It means wait and see. Any higher cash flow from the change in the tax law this year will not be known until the business owner files a tax return next year.

The difference in valuation could be slight, said Ilan Hirschfeld, managing partner of New Jersey advisory services at the accounting firm Marcum. He said he had run calculations showing that a $10 million business could be worth a couple of hundred thousand dollars more under the new law, which might not be worth holding up a divorce settlement.

But not knowing that exact valuation throws more uncertainty into the negotiations. So for couples going through a divorce now, and expecting a big increase in the value of their business next year, it might be better to postpone.

Other Assets

Child support has always been nondeductible and remains so. But some practitioners are reminding their clients to look closely at the tax benefits of different assets.

For instance, couples should weigh receiving a house versus a spouse’s retirement plan, said Jim Mahaney, vice president of strategic initiatives at Prudential. Traditionally, Mr. Mahaney said, the spouse who has custody of the children wants the house. But the new tax changes, particularly in states where deductions for high state and local taxes have been capped, may make the family home less valuable in the long run than a retirement account with a similar value.

Spouses who get the retirement account will not be able to draw down on it until age 59½, but they will have a more solid financial base in their later years. And by opting for the retirement account over the house, they can avoid paying those property taxes.

Examining how the wealthier spouse is going to pay for a child’s education is also important. Given the changes in the tax laws, 529 college savings plans can now be used for private school. They used to be limited to postsecondary and college education.

This can help with school costs sooner, but it presents several problems. One is whether enough money will be left over to pay for college.

But Mr. Mahaney points to another: making sure spouses don’t count the assets in a 529 plan toward their contribution to school or college.

“The rules are the rules,” he said. But the new tax law “adds a different level of complexity, and the negotiation on the amounts is going to be so challenging.”