Family Law Financial Analysis

How to Equitably Calculate Income Disparity for Alimony

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The purpose of alimony in Nevada is to (1) narrow any large gaps between the post-divorce earnings capacities of the parties and (2) allow the recipient spouse to live as nearly as fairly possible to the station in life enjoyed before the divorce. Shydler v. Shydler, 114 Nev. 192, 198, 954 P.2d 37, 40 (1998). When comparing post-divorce earnings capacities of the parties, each spouse's wage earnings and investment earnings are typically combined into a single number for purposes of the analysis. Moreover, the investment earnings component of the analysis is typically calculated based on each spouse's post-divorce investment plans for his or her assets. This article shows why the typical methodology is inequitable, and it suggests a better methodology to use when calculating income disparity for alimony.

THE TYPICAL METHODOLOGY IS UNFAIR

The typical methodology for calculating income disparity is inequitable for two reasons. First, it does not consider wage earnings capacity separately from investment earnings capacity. Wage earnings and investment earnings are generated from different sources that require separate analysis. Wage earnings capacity is derived from one's education and experience. Investment earnings capacity is determined by one's post-divorce assets, and it represents the amount of investment income one can generate by investing his or her assets.

Second, it uses a flawed method of assessing investment earnings capacity. Under the typical methodology, investment earnings capacity is erroneously measured using the investment income a party expects from his or her post-divorce investment plans. Instead, investment earnings capacity is properly measured by the amount of assets a person owns. Two parties with equal assets after a divorce have precisely the same amount of investment earnings capacity. With the same amount of money to invest, each party has the *capacity* to earn the same amount of investment income.

Parties with equal assets will have unequal investment incomes only if they take different amounts of investment risk. Higher investment risk means higher investment return. Therefore, the party who takes on more investment risk will generate a higher amount of investment income. The typical methodology simply compares the expected investment income from each party's post-divorce investment plans. This yields a comparison of the risk/return characteristics of the parties' planned investment decisions instead of a comparison of investment earnings capacity. Comparing investment earnings capacity requires a comparison of the parties' post-divorce asset levels.

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EXAMPLE

Consider a situation in which each spouse earns $80,000 in annual wages and each will have $500,000 in assets after the divorce. Both parties are on the same financial footing post-divorce. Alimony is intuitively unnecessary absent some extraordinary circumstance. Assume the husband's entire $500,000 is invested in his business that generates an annual $150,000 of investment earnings. Husband's total income is equal to $230,000, consisting of $80,000 in wage earnings and $150,000 of investment earnings. Assume the wife's entire $500,000 will be invested in a house that she plans to use as her primary residence after the divorce. The wife's total income is equal to her $80,000 in wage income.

The typical methodology would combine all of the income into one number and conclude there is a $150,000 income disparity on which to base an alimony award. The husband makes $230,000 and the wife makes $80,000. However, alimony does not make sense because the parties are on identical financial footing. They each earn $80,000 in annual wages and each has $500,000 in assets after the divorce.

An equitable methodology would instead separately analyze differences in wage earnings capacity and investment earnings capacity. Moreover, investment earnings capacity would be analyzed based on the amount of assets each party has after the divorce. When the analysis is performed in this manner, there is zero disparity in overall earnings capacity. Wage earnings capacity disparity is zero. They both earn the same annual $80,000 in wages. Investment earnings capacity disparity is also zero. They both have the same $500,000 in assets after the divorce.

DOUBLE DIP AVOIDED

Assessing investment earnings capacity from post-divorce asset levels avoids the inequity that leads to the "double dip" argument. The double dip argument is defined as a business owner arguing against using the same business investment income twice – once for valuation and again for alimony.

The traditional methodology's comparison of the investment income expected from each party's investment plans is actually the source of the inequity underlying the double dip argument. The inequity is not from using the business investment income twice. Rather, the inequity is really about having to pay alimony when there is no legitimate difference in investment earnings capacity between the parties. As described above, the traditional methodology does not accurately measure investment earnings capacity, and therefore the methodology often generates inequitable alimony awards, causing business owners to complain about a double dip.

Business owners avoid that inequity when investment earnings capacity is instead assessed on asset levels. Using an asset-based assessment ensures alimony is only paid when there is a legitimate disparity in investment earnings capacity.

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In the above example, the husband is choosing to invest his $500,000 in a high-risk business that yields $150,000 of annual investment income. The wife is choosing to invest her $500,000 in a paid-for house in which her indirect investment return is the avoidance of paying a rent expense. The typical methodology glosses over the fact that they both have the same $500,000 in assets. Despite having the same investment earnings capacity, the typical methodology awards alimony based on a $150,000 income disparity. The business owner then complains about the inequity by making the double dip argument.

An asset-based assessment of investment earnings capacity recognizes they have the same investment earnings capacity and earn different amounts on their $500,000 because they are choosing different levels of investment risk. The asset-based assessment would award no alimony. The inequity underlying the double dip argument is avoided.

HANDLING UNEQUAL POST-DIVORCE ASSETS

One spouse often emerges from a divorce with more assets than the other spouse. Such a situation arises with pre-marital separate property, for example. The analysis in this situation is relatively simple. First, determine an investment rate of return for a conservative amount of investment risk, such as a portfolio of investment grade bonds. This rate of return can be readily obtained from a number of market sources. Second, apply this rate of return to each party's post-divorce asset levels. The resulting assumed investment income represents each party's investment earnings capacity for purposes of the alimony analysis.

EXAMPLE

Husband earns $120,000 in annual wages, has $250,000 in pre-marital separate property, and will emerge from the divorce with $750,000 as his share of community property. Wife earns $70,000 in annual wages, has no pre-marital separate property, and will emerge from the divorce with $750,000 as her share of community property.

Current market data shows that a portfolio of long-term investment grade corporate bonds yields 4.0%.

I. Post-Divorce Investment Earnings Capacity	Husband	Wife
Post-divorce share of community property	$ 750,000	$ 750,000
Pre-marital separate property	250,000	-
Total post-divorce assets	$ 1,000,000	$ 750,000
Assumed investment rate of return on assets	4.0%	4.0%
Post-divorce investment earnings capacity	$ 40,000	$ 30,000

II. Total Earnings Capacity Disparity	Husband	Wife	Disparity
Post-divorce wage earnings capacity	$ 120,000	$ 70,000	
Post-divorce investment earnings capacity	40,000	30,000	
Total post-divorce earnings capacity	$ 160,000	$ 100,000	$ 60,000

The result is a $60,000 income disparity on which to base alimony. Income taxes are not considered for simplicity of the example. Notice that each party's investment plans for his or her assets are ignored. It does not matter if the parties plan to remain invested in a business, invest in a new primary residence, or otherwise. The actual plans for the assets are irrelevant to determining investment earnings capacity. Moreover, the assumed rate of return is applied to all assets in whatever form - not just liquid assets.

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LEGAL AUTHORITY FOR PROPOSED METHODOLOGY

In awarding alimony, NRS 125.150(9) allows the court to consider whatever factors the court deems relevant. In exercising this broad discretion, the statute provides several factors the court *must* consider, including:

a. The financial condition of each spouse;
b. The nature and value of the respective property of each spouse;
c. The contribution of each spouse to any property held jointly by the parties;
d. The duration of the marriage;
e. The income, earning capacity, age and health of each spouse;
f. The standard of living during the marriage;
g. The career before the marriage of the spouse who would receive the alimony;
h. The existence of specialized education or training or the level of marketable skills attained by each spouse during the marriage;
i. The contribution of either spouse as homemaker;
j. The award of property granted by the court in the divorce, other than child support and alimony, to the spouse who would receive the alimony; and
k. The physical and mental condition of each party as it relates to the financial condition, health and ability to work of that spouse.

The methodology proposed in this article is permissible under NRS 125.150(9) and the broad discretion given to courts in making alimony awards. The proposed methodology has two components.

First, the proposed methodology separately analyzes wage earnings capacity and investment earnings capacity. Section (e) above requires consideration of earnings capacity. Nothing in NRS 125.150(9) prohibits analyzing earnings capacity in two parts.

Second, the proposed methodology assesses investment earnings capacity on the basis of the assets each spouse will have after the divorce using the same assumed rate of return for both parties. This methodology is consistent with NRS 125.150(9), as it considers the value of the property of each spouse (section (b) above), the earnings capacity of each spouse (section (e) above), and the award of property made to the spouse who would receive the alimony (section (j) above).

In assessing investment earnings capacity, there is nothing in NRS 125.150(9) that requires the court to use the expected rates of return from the parties' respective post-divorce investment plans. As discussed earlier, investment earnings capacity is measured by the amount of post-divorce assets. A court making the assessment based on asset levels would be doing so consistent with principles of finance and its broad discretion under the statute.

There is support for using the rate on investment grade corporate bonds as a balanced investment assumption in an income disparity analysis. See Miller v. Miller, 734 A.2d 752, 761 (1999) (New Jersey Supreme Court stating the rate on A-rated corporate bonds "provides a prudent balance between investment risk and investment return" to impute income for alimony analysis).

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CONCLUSION

From a financial standpoint, two parties with the same amount of assets have the same amount of investment earnings capacity. Fairness requires alimony awards to reflect this reality. The typical methodology used in calculating income disparity does not reflect financial reality and generates inequitable alimony awards. Courts should use their broad discretionary powers to correct the problem by assessing investment earnings capacity on the basis of the parties' post-divorce assets using the same assumed rate of return for each party.

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