Tax aspects of divorce and separation

When it comes to legal separation or divorce, there are many complex situations to address. A divorcing couple faces many important decisions and issues regarding alimony, child support, and the fair division of property. While most courts and judges will not factor in the impact of taxes on a potential property settlement or cash payments, it is important to realize how the value of assets transferred can be materially affected by the tax implications.

Dependents

One of the most argued points between separating couples regarding taxes is who gets to claim the children as dependents on their tax return, since joint filing is no longer an option. The reason this part of tax law is so important to divorcing parents is that the federal and state exemptions allowed for dependents offer a significant savings to the custodial parent, and there are also substantial child and educational credits that can be taken. The right to claim a child as a dependent from birth through college can be worth over $30,000 in tax savings.

The law states that one parent must be chosen as the head of the household, and that parent may legally claim the dependents on his or her return.

Example: If a couple was divorced or legally separated by December 31 of the last tax year, the law allows the tax exemptions to go to the parent who had physical custody of the children for the greater part of the year (the custodial parent), and that parent would be considered the head of the household. However, if the separation occurs in the last six months of the year and there hasn't yet been a legal divorce or separation by the year's end, the exemptions will go to the parent that has been providing the most financial support to the children, regardless of which parent had custody.

A non-custodial parent can only claim the dependents if the custodial parent releases the right to the exemptions and credits. This needs to be done legally by signing tax **Form 8332,** *Release of Claim to Exemption*. However, even if the non-custodial parent is not claiming the children, he or she still has the right to deduct things like medical expenses.

Child support payments are not deductible or taxable. Merely labeling payments as child support is not enough -- various requirements must be met.

Alimony

Alimony is another controversial area for separated or divorced couples, mostly because the payer of the alimony wants to deduct as much of that expense as possible, while the recipient wants to avoid paying as much tax on that income as he or she can. On a yearly tax return, the recipient of alimony is required to claim that money as taxable income, while the payer can deduct the payment, even if he or she chooses not to itemize.

Because alimony plays such a large part in a divorced couple's taxes, the government has specifically outlined what can and can not be considered as an alimony expense. The government says that an alimony payment is one that is required by a divorce or separation decree, is paid by cash, check or money order, and is not already designated as child support. The payer and recipient must not be filing a joint return, and the spouses can not be living in the same house. And the payment cannot be part of a non-cash property settlement or be designated to keep up the payer's property.

There are also complicated recapture rules that may need to be addressed in certain tax situations. When alimony must be recaptured, the payer must report as income part of what was deducted as alimony within the first two payment years.

Property

Many aspects of property settlements are too numerous and detailed to discuss at length, but separating couples should be aware that, when it comes to property distributions, basis should be considered very carefully when negotiating for specific assets.

Example: Let's say you get the house and the spouse gets the stock. The actual split up and distribution is tax-free. However, let's say the house was bought last year for $300,000 and has $100,000 of equity. The stock was bought 20 years ago, is also worth $100,000, but was bought for $10,000. Selling the house would generate no tax in this case and you would get to keep the full $100,000 equity. Selling the $100,000 of stock will generate about $25,000 to $30,000 of federal and state taxes, leaving the other spouse with a net of $70,000. While there may be no taxes to pay for several years if both parties plan to hold the assets for some time, the above example still illustrates an inequitable division of assets due to non-consideration of the underlying basis of the properties distributed.

Under a recent tax law, a spouse who acquires a partial interest in a house through a divorce settlement can move out and still exempt up to $250,000 of any taxable gain. This still holds true if he or she has not lived in the home for two of the last five years, the book states. It also applies to the spouse staying in the home. However, the divorce decree must clearly state that the home will be sold later and the proceeds will be split.

Complications and tax traps can also occur when a jointly owned business is transferred to one spouse in connection with a divorce. Professional tax assistance at the earliest stages of divorce are recommended in situations where a closely held business interest is involved.

Retirement

When a couple splits up, the courts have the authority to divide a retirement plan (whether it's an account or an accrued benefit) between the spouses. If the retirement money is in an IRA account, the individuals need to draw up a written agreement to transfer the IRA balance from one spouse to the other. However, if one spouse is the trustee of a qualified retirement plan, he or she must comply with a Qualified Domestic Relations Order to divide the accrued benefit. Each spouse will then be taxed on the money they receive from this plan, unless it is transferred directly to an IRA, in which case there will be no withholding or income tax liability until the money is withdrawn.

Extreme caution should be exercised when there are company pension and profit-sharing benefits, Keogh plan benefits, and/or IRAs to split up. Unless done appropriately, the split up of these plans will be taxable to the spouse transferring the plan to the other.

Tax Prepayment and Joint Refunds

When a couple prepays taxes by either withholding wages or paying estimated taxes throughout the year, the withholding will be credited to the spouse who earned the underlying income. In community property states, the withholding will be credited equally when spouses each report half of their income. When a joint refund is issued after a couple has separated or divorced, the couple should consult a tax advisor to determine how the refund should be divided. There is a formula that can be used to determine this amount, but it is wisest to use a qualified individual to make sure it is properly applied.

Legal and Other Expenses

To the dismay of most divorcing couples, the massive legal bills most end up paying are not deductible at tax time because they are considered personal nondeductible expenses. On the other hand, if a part of that bill was allocated to tax advice, to securing alimony, or to the protection of business income, those expenses can be deducted when itemizing. However, their total -- combined with other miscellaneous itemized deductions -- must be greater than 2% of the taxpayer's adjusted gross income to qualify.

Divorce planning and the related tax implications can completely change the character of the divorcing couple's negotiations. As many divorce attorneys are not always aware of these tax implications, it is always a good idea to have a qualified tax professional be involved in the dissolution process and planning from the very early stages. If you are in the process of divorce or are considering divorce or legal separation, please contact the office for a consultation and additional guidance.