Tax implications of divorce

Unfortunately, in addition to the difficult personal issues associated with divorce, there are several tax concerns that need to be addressed in order to keep tax costs to a minimum.

Support provisions. Where one spouse is to be making support payments to the other upon divorce or separation, the payments are deductible by the payor and taxable to the payee if they qualify under the tax rules for "alimony." To qualify, the payments must (1) be required under the divorce decree or separation agreement (i.e., voluntary or "extra" payments won't qualify), (2) be in cash only (not goods or services), and (3) be required to end at the death of the recipient spouse. Also, (4) the parties must be living in separate households. The parties can elect to have payments that qualify be treated as not qualifying (but not vice versa).

Support payments for children ("child support") aren't deductible by the paying spouse (or taxable to the recipient). These include payments specifically designated as child support as well as payments which otherwise might look like alimony but are linked to an event or date related to a child. For example, say a spouse is to pay "alimony" of $3,000 a month, dropping to $2,000 a month at a specified date. If the date coincides with a child's 18th or 21st birthday, the "extra" $1,000 will be characterized as child support and not be deductible by the paying spouse (or taxable to the recipient spouse).

Tax planning for support payments generally seeks to make them deductible if the paying spouse is in a higher tax bracket than the recipient, as is often the case. The tax savings for the paying spouse can be shared with the recipient through higher payment amounts or other benefit provisions. For example, if having payments qualify as alimony will save the paying spouse $5,000 in tax and will cost the receiving spouse only $2,000 (determined by multiplying the alimony amount by the individual's marginal income tax bracket), the paying spouse can offer additional payments in the divorce negotiations to cover the recipient's tax cost and a share of the additional tax savings.

Since alimony payments are required to end at the death of the receiving spouse, as noted above, the parties may wish to provide for life insurance for that spouse as part of the arrangement.

Dependency exemptions. To some extent, the parties can determine who is entitled to claim the dependency exemption for their dependent children. The exemption for the child goes to the spouse who has legal custody of the child. However, that spouse can waive his or her right to the exemption, thus allowing the noncustodial spouse to claim it. In general, tax planning calls for the spouses to agree to have the exemption go to the spouse who can extract the greater tax benefit from it. As discussed above in connection with tax savings from support arrangements, the tax benefit can then be "shared" with the other spouse via increased support payments or in some other fashion.

The dependency exemption entitles the spouse who claims it to more than just the exemption. For example, the child tax and the higher education (Hope and Lifetime learning) credits are only available to the spouse who claims the child as a dependent. (Note, however, if the custodial parent waives the right to the exemption, the custodial parent can still claim the child care credit for qualifying expenses if the child is under 13.)

If a custodial spouse is waiving the right to the dependency exemption for a child, it's done on Form 8332. This can be done on an annual basis or one time to cover future years. Where the waiving spouse will be receiving support payments from the other spouse, the waiving spouse often prefers the annual approach so he or she can refuse to grant the waiver if support payments are late or have been missed.

Property settlements. When property is split up in connection with a divorce, there are usually no immediate tax consequences. Thus, property transferred between the spouses won't result in taxable gain or loss to the transferring spouse. Instead, the receiving spouse takes the same basis (cost) in the

property that the transferring spouse had. (The receiving spouse may have to pay tax later, however, when the recipient spouse sells the property. For example, if a spouse receives a $300,000 vacation home, but the transferring spouse's basis was only $150,000, the recipient spouse will have a taxable gain if he or she later sells the house for more than $150,000, unless the spouse qualifies to exclude part or all of the gain by first making the house his or her principal residence). This “nonrecognition rule” also applies to certain transfers, incident to divorce, to a spouse or former spouse, of so-called nonstatutory stock options and/or rights to nonqualified deferred compensation that an individual has received as compensation for employment and that haven't yet been recognized for income tax purposes. Moreover, the transferee spouse or former spouse, rather than the transferor, is taxed on the income attributable to these transferred options or deferred compensation rights.

Special tax rules apply to certain categories of property. In particular, please call me to make sure the arrangements for your home, pension benefits, and certain business interests, discussed below, are properly structured to minimize potential tax costs.

Personal residence. In general, if a married couple sells their home in connection with divorce or legal separation they should be able to avoid tax on up to $500,000 of gain (as long as they owned and used the residence as their principal residence for two of the previous five years). If one spouse continues to live in the home and the other moves out (but they remain owners of the home), they may still be able to avoid gain on the future sale of the home (up to $250,000 each), but special language may have to be included in the divorce decree or separation agreement to protect the exclusion for the spouse who moves out. If the couple doesn't meet the two year ownership and use tests, any gain from the sale may qualify for a reduced exclusion by reason of unforeseen circumstances.

Pension benefits. A spouse's pension benefits are often part of a property settlement. When this is the case, the commonly preferred method to handle the benefits is to get a “qualified domestic relations order (QDRO).” A QDRO gives one spouse the right to share in the pension benefits of the other and taxes the spouse who receives the benefits. Without a QDRO the spouse who earned the benefits will still be taxed on them even though they are paid out to the other spouse.

A QDRO isn't needed to split up an IRA, but special care must be taken to avoid unfavorable tax consequences. For example, if an IRA owner were to cash out his IRA and then pay his ex-spouse her share of the IRA as stipulated in a divorce decree, the transaction could be treated as a taxable distribution (possibly also triggering penalties), for which the IRA owner would be solely responsible. However, the taxes and penalties can be avoided, if specific IRS-approved methods for transferring the IRA from one spouse to the other are used. For example, money can be transferred tax-free from one spouse's IRA to the other spouse's IRA in a trustee-to-trustee transfer, as long as the transfer is required by a divorce decree or separation agreement. Also, the transfer shouldn't take place before the divorce or separation is final, or it may be treated as a taxable distribution.

Business interests. When certain types of business interests are transferred in connection with divorce or separation, care must be taken to make sure “tax attributes” aren't forfeited. In particular, interests in S corporations may result in “suspended” losses, i.e., losses that are carried into future years instead of being deducted in the year they are incurred. Where these interests change hands in connection with a divorce, the suspended losses may be forfeited. If a partnership interest is transferred a variety of more complex issues may arise involving partners' shares of partnership debt, capital accounts, built-in gains on contributed property, and other complex issues.

I'm not suggesting that the interests discussed above shouldn't be part of property settlement negotiations: only that the parties be aware of the tax consequences that their transfer may generate.

Estate planning considerations. The upheaval a divorce causes in family relations and property holdings makes it imperative for the parties to reassess their wills and estate plans in connection with the divorce. First, the typical will in which all property is left to a surviving spouse is no longer likely to reflect

the testator's wishes. Mutual family goals, often incorporated in reciprocal wills, are likely to have changed substantially. Second, the property to be left by the spouses may have changed hands via a property settlement. One spouse may be getting substantial holdings he or she didn't previously possess, making it necessary to devise a new estate plan. Finally, guardianship and trustee issues for surviving minor children must be addressed. That is, who will manage the assets of, and serve as guardian for, minor children in the event of the death of the parents.

Medical insurance. If your spouse participates in an employee group health plan that is subject to COBRA, you should know that the plan has the obligation to make COBRA health care continuation coverage available to you, as a qualified beneficiary, if there is a divorce or legal separation. This availability of health coverage extends for 36 months, beginning on the date of the divorce or legal separation. You, however, would have to pay for the coverage (unless, of course, the divorce court orders your spouse to pay for it). This option to buy COBRA health care coverage is available to you even if your spouse discontinued your coverage while the divorce was pending.

Tax records. Make sure you get copies of, or access to, any records or documents that can have an impact on your tax situation. You need copies of joint returns filed with your spouse along with supporting documentation. Also, records relating to the cost of jointly owned property or property transferred to you in connection with the divorce are essential. You will need to establish cost when these assets are eventually sold. And, of course, all documents relating to the divorce or separation itself should be retained for tax (and other legal) purposes.

Filing status. The timing of your divorce or separation can have an impact on how you file your tax return. If a “final” decree or divorce or, in the case of separation, decree of separate maintenance, is issued by the end of the year, then you can't file your tax return for the year as a married person. Your filing status will be “single.” However, if you cover more than half the costs of a household in which a child of yours lives, you may qualify for more favorable “head of household” rates.

If an above-described decree hasn't been issued by year-end, you are treated as still married even if you are separated from your spouse under a separation agreement or “nonfinal” decree. In this case, you may still file jointly with your spouse. This filing status may result in lower overall tax for you and your ex-spouse, but may put you at risk for an unpaid tax obligation of your spouse's (although you may be protected under “innocent spouse”rules, and an election to limit your liability may be available in certain circumstances). It also requires contact between the parties to prepare the joint return, which may not be desirable in some circumstances. Further, the alimony deduction discussed above can't be taken on a joint return.

The other available filing status is “married filing separately,” which is the least favorable status. However, again, if you cover more than half the costs of a household in which a child of yours lives, *and your spouse hasn't been a member of the household during the last six months of the year,* you may qualify for a more favorable filing status.

Providing income data to spouse who has custody of child under 14. Be aware that if while you and your spouse are still considered married, you and your spouse decide to file separate returns, and your spouse has custody of your child under age 14 who has investment income, you may have to provide to your spouse any information about your taxable income that's needed to properly figure the child's income tax under the kiddie tax rules (which tax the child's investment income at the parent's highest rate). If you will have custody of the child, you may be in the position of having to get income information from your spouse.

Adjusting income tax withholding. The changes caused by divorce may require you to adjust the amount of income tax that your employer withholds from your paycheck. The calculation of your withholding on the Form W-4, Employee's Holding Allowance Certificate, that you gave to your employer is based on your married status and on the earnings of both spouses. When you get divorced, you

should submit a new Form W-4 with the revised information. The fact that deductible alimony payments will be made (or taxable alimony received) should also be taken into account. This will ensure that the correct amount of tax is withheld.

Notifying IRS of a new address or name change. If you will be moving, or if you are changing your name because of divorce, file Form 8822 with IRS so you will receive any notices or correspondence from IRS promptly.

Deducting legal fees. Finally, to what extent can you deduct the legal fees incurred in connection with the divorce? In general, since a divorce is a "personal" undertaking, the legal fees are nondeductible. However, as you can readily see from this discussion, many complex tax issues can be involved in a divorce. And a fee paid for tax advice (including setting up the support arrangement), is deductible as a miscellaneous itemized deduction. (This means it's added to other items in this category, if any, e.g., investment expenses, and is deductible to the extent the total exceeds 2% of adjusted gross income.)

To get a tax deduction for the part of your legal fee that represents tax advice, it's important to have your attorney indicate on his or her bill to you what portion represents tax-related service. If your attorney merely submits a bill "for legal services rendered" you may have difficulty convincing IRS how much, if any, is deductible.

Other legal fees in connection with divorce that may save you taxes include costs to collect alimony payments (but not costs to resist collection). Also, if legal work is involved in getting marital assets, the part of fee allocable to the property can be added to its basis. This can save you tax when the property is disposed of.