An Attorney’s Guide To Divorce-Related Tax Issues

There may be no glory in being a family law attorney these days, especially when it comes to dealing with the often challenging economic consequences in a divorce action.

Clients may initially contact you with one issue related to their potential divorce, but often these concerns can quickly manifest as emotions and pressures begin to develop. Perhaps the questions attorneys resist the most or feel least comfortable in answering pertain to divorce-related tax matters. Many individuals, including those contemplating divorce, will be reaching out to you for answers to a variety of tax-related divorce questions. So, this may be the best time to revisit some of the questions you may be faced with.

Here are ten divorce-related tax issues that all matrimonial and family law attorneys should know.

1. Taxability of Assets Distributed Incident to Divorce

In many instances one of the most disputed issues in a divorce is the distribution of the marital assets. This is commonly referred to as “equitable distribution” or “ED”. Under the Internal Revenue Code (IRC) Section 1041 (a), no gain or loss is recognized on the transfer (acquisition or distribution) incident to divorce provided such transfer occurs within one year after the divorce or related to the ending of the marriage.

The ending of the marriage is defined pursuant to a divorce or separation agreement and occurs within six years after the date on which the marriage ended.

Practice Tip: Often, one of the most significant marital assets is the marital residence and/or a business. The values of these assets should be appraised by an independent credentialed valuation expert in the early stages of the divorce proceeding.

2. Tax Deductibility of Professional Fees

Legal and other professional fees related to getting a divorce are generally not tax deductible. These non-deductible costs include expenses related in arriving at financial settlements and retaining income-producing property. However, some legal and accounting expenses can be deducted as a miscellaneous itemized deduction, subject to the 2% limitation (and also as a preference for alternative minimum tax purposes). Here is a short list of some of these exceptions:

- Fees related to tax advice related to a divorce,
- Fees to determine or collect alimony,
- Fees to determine estate tax consequences of property settlements, and
- Appraisal and actuary fees to determine tax liabilities or to assist in obtaining alimony

Practice Tip: When your client retains an accounting/tax professional ask them to prepare their invoices with specific descriptions so that the tax deductible portion of their charges can be easily determined.

3. Alimony v. Child Support

In simple terms, alimony is taxable to the recipient and deductible by the payer. To qualify as alimony under IRC Section 71(b) the payments must meet the following requirements:

- Payments are required under a written divorce or separation agreement,
- The payment cannot be designated as "not alimony",
- Spouses may not be members of the same household,
- Payments may not be treated as child support,
- Payments must cease upon death of recipient, and
- The parties cannot file a joint tax return

Child Support is never taxable, and there are a few other common payments that do not qualify as alimony, such as:

- Non-cash transfers,
- Payments for use of property, and
- Payments to keep up the payer's property

In addition, an often neglected issue pertains to the short-fall of child support obligations. When an individual is obligated to pay (both) alimony and child support, payments are first applied to satisfy child support obligations and then to alimony. In other words, child support obligations must be fully satisfied before any amount of alimony is considered deductible.

Practice Tip: When structuring alimony agreements one should be conscious of the possible applicable alimony recapture rules. If there is a decrease or termination of alimony during the first three calendar years, recapture rules apply if the alimony in the second or third calendar year is $15,000 less than in the prior year. The recapture provision may be initiated by one or more of the following:

- *Failure to make timely payments,*
- *Change in divorce or separation agreement,*
- *Reduction in spouse support needs, and*
- *Reduction in payers ability to provide support*

4. Sale of Personal Residence

If you live in your "Principal Residence" for any two of the last five years you are eligible for a capital gain exclusion upon the sale of the home. This exclusion is $250,000 for a single taxpayer and $500,000 for a married couple. Because of the significant difference in tax treatment, the tax consequences related to the sale of the marital home should be considered early on in the divorce settlement negotiations.

Practice Tip: If the sale of the marital residence is contemplated, consider the transaction prior to the termination of the marriage in order to take advantage the higher exclusion amount in order to secure more proceeds from the sale.

5. Filing Status

An individual's marital status is determined as of the last day of the calendar year – December 31st. Married individuals can file jointly or married filing separate. When the parties file jointly each is jointly liable for the tax obligation, regardless of what a divorce instrument may say.

The married filing separate status is the highest tax rate. When spouses file separate returns they both must utilize the standard or itemized deductions. The first one to file establishes the requirements for the other to follow. When married individuals file their tax returns separately we often find other critical issues being considered.

If an individual is divorced as of December 31st, even if married and living together with their ex-spouse sometime during the year, they must file as a single taxpayer or head of household for that year.

For those that are still married at the end of the year but were legally separated on December 31st or have not lived with their spouse for the last six months of the year – they may be able to file as head of household. This filing status is attractive because the tax rates are significantly less than for those filing as married filing separate.

To file head of household a number of requirements must be met:

- The individual must have paid more than half of the cost of keeping a home for a child or other qualifying person,
- This individual is entitled to claim the qualifying person as a tax exemption, and
- The qualifying person must have lived in the individual's home for more than half the year

Practice Tip: Income Tax projections utilizing different scenarios are an often neglected but valuable planning tool. This exercise should be performed for years before and after the termination of the marriage.

6. <u>Children/Dependents Personal Exemptions</u>

Generally, the custodial parent is entitled to the dependency exemption as long as the parents (individually or together) provide at least one-half of the dependents support. However, there are two exceptions to this general rule:

- When the custodial parent relinquishes the rights to the exemption, or
- When a multiple support agreement is established

Practice Tip: Dependent exemptions often vary by agreement. When preparing these arrangements make sure you consider the age of the child/dependent and the taxable income of each parent.

7. <u>Deductibility of Mortgage Interest & Real Estate Taxes</u>

When a couples' principal residence is jointly owned and the mortgage interest and real estate taxes are paid from a joint account there is a presumption that these payments are attributed to each party on a 50/50 basis.

However, when a home is jointly owned and these payments are paid directly by the non-occupant spouse, half of the mortgage interest and real estate taxes is deductible to the paying spouse as an itemized deduction and the remainder qualifies as alimony. The occupying spouse must report these amounts as income (alimony) but is able to deduct the interest and taxes as an itemized deduction.

If the home is owned only by the occupying spouse but the non-occupying spouse is still obligated on the mortgage, the non-occupying spouse can only deduct the mortgage interest if a minor child of the marriage resides in the home. The non-occupying spouse cannot deduct any of the real estate taxes, since he or she has no ownership in the property.

Alternatively, if the non-occupying spouse solely owns the house and pays the mortgage interest and real estate taxes then those amounts can be deducted in their entirety as an itemized deduction. The occupying spouse would not have to report these amounts as alimony.

Practice Tip: Don't assume that the marital residence is jointly owned by each the husband and wife. Inquire as to who owns the property and who is obligated on the primary and secondary mortgages.

8. <u>IRA's and Retirement Plans</u>

A Qualified Domestic Relations Order (QDRO) is a useful tool to designate a portion of a qualified retirement plan to the other spouse. This vehicle allows the distribution of the marital asset without damaging the integrity of the plan or the creation of a taxable event. Benefits are taxed when distributions are made, not when the QDRO is established. QDRO's do not apply to Individual Retirement Accounts (IRA's); however, IRA's transferred pursuant to a divorce or separation agreement is not a taxable event.

Practice Tip: The use of a QDRO is an accessible tool to facilitate the equitable distribution of assets when there are limited liquid assets.

9. <u>Stock Option & Deferred Compensation Plans</u>

The transfer of an interest in a non-statutory stock option or a non-qualified deferred compensation plan incident to a divorce is not a taxable event. However, income is reported when the former spouse exercises the stock options or when the deferred compensation is paid (or made available).

Practice Tip: Stock option & deferred compensation plans can be identified within employment contracts and/or annual wage reporting statements. Obtain the periodic statements (monthly, quarterly, annual, etc.) for your file.

10. <u>Innocent Spouse Relief</u>

There are currently three sections of Internal Revenue Code that provide relief from tax liability to spouses:

- Innocent Spouse (IRC Section 6015 (b)),
- Separation of Liability (IRC Section 6015 (c)), and
- Equitable Relief (IRC Section 6015 (f))

When applicable, the courts have considered the following factors to determine their applicability:

- Knowledge,
- Economic hardship,
- Benefit,
- Compliance with tax laws,
- Tax liability attributed to non-requesting spouse,
- Marital status, and
- Spousal abuse

Practice Tip: If you plan to invoke the innocent spouse rule prepare your argument by addressing as many of the above factors discussed above. IRS Form 8857, Request for Innocent Spouse Relief, is filed separately, not with the couples' individual income tax returns.

We hope this brief summary is of value to you and your practice. Your questions or comments regarding this information are always welcome.

For additional timely information to assist your family law and matrimonial law practice please feel free to visit our website www.msgcpa@msgcpa.com, blog www.forensicperspectives.com, or call our offices.