“Unhappily ever after: Tax issues of a failed marriage”

Statistics show that more than 50 percent of marriage in the United State end in divorce.

The process of a divorce can create tremendous animosity between the parties, and this can lead to difficult financial issues for those affected by the split. There are many complex federal tax issues that need to be planned for, or they will create tremendous pitfalls. The Internal Revenue Code of 1986, as amended (“Code”) contains several provisions that provide specific guidance for divorce-related transactions.

Perhaps the most widely known financial aspects of a divorce are alimony and spousal support. Under Code Section 71, alimony is deductible by the payor and is included as income by the payor’s former spouse. There are, however, several requirements that must be met for alimony to be deductible.

These requirements include the following: The payment must be in cash; the payment must be made in accordance with a divorce or written separation agreement; the spouses, divorced or legally separated, must reside in separate households; any payment to a third party must be evidenced by a timely executed writing; the liability to make payments must cease with death; the divorced parties do not file a joint return; and the divorce or separation agreement does not designate non-alimony treatment.

The regulations promulgated by the U.S. Treasury under Section 71 are specific, and they provide a great deal of information surrounding each one of these requirements. The Internal Revenue Service and the courts have provided additional guidance, but in short, failure to comply with the statutorily described requirements will disallow alimony as a deduction.

The other well-known area of payment in a divorce situation is child support. Under Section 71(c) of the Code, cash payments constituting child support are excluded from the definition of alimony, and so they are not deductible by the payor. One spouse's payment to the other spouse is treated as fixed child support if it meets one or the following four tests:

- The payment is designated as child support by a divorce agreement;
- The payment amount reduces if a child-related contingency occurs;
- The payment amount reduces at a time tied to specific birthdays; or,
- The payment amount reduces at a time clearly associated with a child-related contingency.

The Code provides several examples of "contingency," including attaining a specified age or income level, marrying, dying, leaving school, leaving the supported household or gaining employment. It is critical that these requirements be considered and appropriately incorporated into the financial planning process, so child support payments are not confused with alimony obligations.

Transfers of property

Property transfers between former spouses often take place during the course of a divorce. The tax treatment of these transfers is generally governed by Code Section 1041.

Section 1041(c) provides that no gain or loss is recognized on a transfer of property from an individual to, or in trust for, a spouse or former spouse if the transfer is incident to a divorce. A transfer subject to this provision is treated as a gift for income tax purposes.

Thus, the basis carries over to the transferee. The transferee's holding period includes the holding period includes the holding period of the transferor. To document a Section 1041 transaction, the transferor must provide the transferee with records that assist with the proper determination of the adjusted basis and holding period of the property as of the transfer date.

For the transfer of property to be viewed as incident to divorce, the transfer must occur within one year after the date the marriage ceases. If the transfer occurs after one year, it falls under provisions related to the cessation of the marriage, but it is only considered as such if the transfer is part of a divorce or separation instrument and the transfer occurs within six years after the date the marriage ceases.

In addition to a basic understanding of the general rules of application, the parties should consider any unique or unusual property transactions that may occur regarding property transfers.

Dependency exemption

Another important consideration is which spouse will claim the dependency exemption for a child or children. For a child to be a qualifying dependent, she must have the same principal place of abode as the taxpayer claiming the dependency exemption for more than one-half of the taxable year. The custodial parent, therefore, generally is entitled to the exemption.

However, Section 152(e) allows the noncustodial parent to claim the exemption if a multiple support agreement allows the child to be claimed as a dependent by a taxpayer other than the custodial parent, or if the custodial parent releases their right to the exemption to the noncustodial parent.

Filing status

Marital status, for the purposes of Code Section 7703(a)(1), is determined on the last day of the taxable year. If divorced taxpayers happened to still be married on the last day of the taxable year, they are treated as married for that year. They may file married filing jointly or they may file married filing separately.

An individual who is married can be treated as unmarried it the spouses are legally separated under a decree of divorce or separate maintenance, or if a spouse is abandoned, as defined under Section 7703(b).

A divorced parent may be able to tile as head of household, which generally has a slightly lower rate than single taxpayers. To meet this requirement, the taxpayer must be unmarried and maintain a household that is the principal residence of a child for over half the year, and the taxpayer must be entitled to claim the child as a dependent.

When representing divorced taxpayers, it is also important to consider the rules of joint and several liability. With very limited exceptions, taxpayers filing a joint return are jointly and severally liable for nay income tax, penalty and interest arising out of that return. Even though a higher overall tax may be paid by pursuing married filing separately, you must consider liability issues when counseling clients who are getting a divorce about their filing status.

Advisor's fees

The Supreme Court concluded in U.S. v. Gilmore (372 U.S. 39 (1963) that attorney's fees and expensed incurred in connection with obtaining a divorce are considered nondeductible personal expenses, because divorce is considered a personal proceeding. Certain divorce-related fees, however, may be allocable to collection of income or providing tax advice, and thus may be deductible under Section 212.

It is therefore important for people to separate professional fees into amounts that are considered personal, and thus nondeductible, and those that provide advice regarding collection of income or tax advice and may be deductible.

The Section 212 expenses, of course, are itemized deductions subject to the 2 percent adjusted gross income floor for miscellaneous itemized deductions, but it the numbers are large enough, this could result in significant tax savings.

Estate planning

During a divorce, there are a number of estate planning considerations that must be reviewed. In most circumstances, the divorcing spouses need to review and revise their estate plans. They will both need new wills that make fiduciary designations such as executor, personal representatives, attorney-in-fact, health care agents, trustees and possibly guardians for minors.

Married individuals are entitled to an unlimited marital deduction for property gifted to a spouse or property passing to a surviving spouse. After a divorce is final, and the marital relationship ends, the unlimited marital deduction no longer applies. Therefore, review estate tax liquidity needs when planning for the estate. This review may uncover a need for life insurance, which can be owned by an irrevocable life insurance trust. This could allow for the creation of cash that could be used to help with the payment of estate and other liabilities.

After a divorce, beneficiary designations must be revised in a client's personal accounts. Retirement plans may name a former spouse, and life insurance may have an inappropriate beneficiary. These items may seem like minor details, but, in a worst-case scenario, failure to give attention to these matters can create a financial disaster for a client or possibly the client's children or other beneficiaries.

When advising clients, consider the possible use of an alimony trust under Section 682. This type of trust protects the recipient spouse by transferring assets into this trust. This irrevocable trust would pay certain amounts to the recipient spouse, who is taxed on the income received. This trust could be structured in a manner that any remaining balance would revert to the grantor, or an heir, if the recipient spouse remarries or dies.

Principal residence

If a principal residence must be sold in connection with a divorce, it may be more appropriate to sell the home while it is still jointly owned, prior to the divorce. If a residence is used and owned as a principal residence for two out of five years, and exclusion from income is available in the amount of $250,000 for a single individual, but the exclusion is $500,000 for married individuals filing a joint return.

There are special rules regarding the imputed use of a home that may be useful in a divorce. A spouse owning a home can claim that home as a principal residence during any period that the other spouse is granted use of the home.

For example, assume a husband owns a home. In connection with a divorce, the husband moves out and the wife is granted use of the home under the divorce agreement. The wife's use of the home during this period is attributed to the husband. Thus, the husband can claim a $250,000 exclusion if all the requirements are met when the home is sold.

This same rule of imputed ownership can apply when a home is transferred to one spouse under a divorce decree. Prior ownership is added to the ownership time of the spouse who received the house. Thus, the recipient spouse may qualify for the $250,000 exclusion at the time of sale.

Finally, if a principal residence remains jointly owned after divorce, it is possible that each spouse may be entitled to a $250,000 exclusion, thus entitling them to a full $500,000 exclusion.

Retirement plans

Other very important assets to consider in a divorce are qualified pension plans and individual retirement accounts.

When dealing with qualified retirement plans, a Qualified Domestic Relations Order is a judgment, decree or order that provides for an alternative payee of the qualified plan. The rules surrounding QDRO’s are very specific, and failure to follow these rules can result in immediate taxation.

Often, the trustee of a qualified retirement plan has a form document that can be used for this purpose. Review that document and see if it fits a divorcing couple’s particular circumstances, and if not, provide the trustee with input regarding what is needed.

IRA’s do not require a QDRO. An IRA can be split pursuant to a divorce decree or written agreement. If done in the appropriate manner, there is no tax on the transfer. After the transfers, the recipient spouse becomes the owner of that portion of the IRA. Distributions are subject to regular tax treatment, and the owner can name any beneficiary.

The best way to deal with an IRA is to have the divorcing spouses split the IRA pursuant to a decree or written agreement, and have the spouses set up their own retirement accounts for these amounts.

Conclusion

The tax and estate implications resulting from a divorce are complex and far-reaching. Failure to give consideration to the matters discussed in this article can result in unexpected and financially devastating problems for your clients.

As you provide advice and counsel to your clients, provide the appropriate analysis of these issues and give the best counsel possible regarding these very difficult personal circumstances.