



DIVORCE AND SEPARATION

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When you think about divorce and separation, the first issue that comes to mind probably is not how it is going to affect you from a tax standpoint. However, the way you structure payments made “incident to” separation or divorce—regardless of whether they are made under an agreement you and your spouse work out or a court-ordered settlement—can have a tremendous impact on your income tax liability and, therefore, your overall financial condition.

The tax rules applicable to payments made from one spouse to another incident to divorce or separation should be given serious consideration *before* entering into a separation agreement or divorce settlement. In addition to having an attorney represent you when you are involved in a divorce or separation, your tax advisor should review any proposed agreement or settlement before it is finalized.

This guide highlights the tax consequences of certain payments that may be arranged as part of a divorce settlement, as well as other tax issues that arise in connection with the events of divorce or separation. The areas that will be discussed include:

- Alimony and separate maintenance payments;



- Child support;
- Qualified Domestic Relations Orders (QDROs);
- Individual retirement arrangements (IRAs);
- Property settlements and transfers of property incident to divorce;
- Jointly-owned businesses; and
- Innocent spouse relief.

Three types of payments or transfers

If you are going through a separation and/or a divorce, all payments or transfers of property – either from you to your spouse or from your spouse to you – fit into one of the following three categories:

- Nontaxable transfers of property (aka property settlements);
- Taxable alimony or separate maintenance payments; and
- Nontaxable child support payments.

It can often be unclear whether a particular payment or transfer of property is alimony or child support. Additionally, it can sometimes also be difficult to

determine whether certain payments or transfers of property constitute taxable alimony or nontaxable property transfers. The tax treatment of each type of payment is different, making it extremely important to understand the characteristics of each type from the IRS's perspective.

ALIMONY

Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not made under a divorce or separation instrument.

Alimony and separate maintenance payments constitute taxable income to the payee-spouse and are deductible by the payer-spouse. However, both parties can agree to change the tax treatment of qualified alimony payments by designating them as nonalimony, or otherwise agreeing that the payments will be tax-free to the payee-spouse and nondeductible by the payer-spouse.

Caution. You can't just label a payment as alimony, however, and expect it to be treated as such for tax purposes. Many requirements apply, which are discussed below.

To qualify as alimony, payments must meet several requirements:

- The payments must be in cash;
- They must be received by or on behalf of the payee-spouse under a divorce or separation instrument;

- Spouses who are legally separated under a decree of divorce decree or separate maintenance are not living in the same household;
- The payment obligation ends upon the payee's death;
- The parties do not file a joint return with each other; and
- The payments are not child support.

Comment. State laws differ as to the treatment of alimony payments after remarriage of the payee-spouse. When state law provides that alimony stops upon the payee-spouse's remarriage, the payer-spouse's continuing payments under a final decree of divorce after the ex-spouse has remarried are not made under a legal obligation to pay alimony and are generally not includable in the ex-spouse's income.

Assuming you structure your payments to meet these basic requirements, if you are the payer-spouse, you will be able to deduct your payments and your spouse will be taxed.

But you have the flexibility, if you both agree, to *not* have future payments treated as alimony (to be tax-free to your spouse and nondeductible by you). This will save taxes for the recipient spouse. As a payer-spouse, you may agree to do this if you don't need the deduction, or your former spouse is in a higher tax bracket. Taxes in any event usually figure into the amount of alimony paid each month.

Note. Payments that may otherwise qualify as alimony are not deductible by the payer if they are the recipient spouse's part of community income (if the spouse lives in a community property state). They are deductible as alimony only to the extent they exceed that spouse's portion of community income.

Caution. Since no taxes are withheld from alimony payments, you may need to make estimated tax payments or increase the amount withheld from your paycheck.

Not all payments under a divorce or separation instrument are alimony. Alimony does not include:

- Child support;
- Non-cash property settlements;
- Payments that are your spouse's part of community income;
- Payments to keep up the payer spouse's property; or
- Use of property.

Example. Under your written separation agreement, your spouse lives rent-free in a home you own and you must pay the mortgage, real estate taxes, insurance, repairs, and utilities for the home. Because you own the home and the debts are yours, your payments for the mortgage, real estate taxes, insurance, and repairs are not alimony. Neither is the value of your spouse's use of the home.



What is a divorce or separation instrument?

A divorce or separation instrument is a:

- Decree of divorce or separate maintenance, or a written instrument incident to the decree;
- Written separation agreement; or
- Decree requiring a spouse to make payments for the support or maintenance of the other spouse, including a temporary support order.

Caution. In all events, oral agreements or oral modifications don't count for tax purposes.

Payments of alimony to third parties

When the spouse who is required to pay alimony instead makes cash payments to a third party on behalf of the other spouse, these payments may qualify as alimony or separate maintenance payments. To qualify, the payments must be required by the divorce or separation instrument and must meet all the requirements above to be classified as alimony.

Qualifying payments. Cash payments of rent, mortgage, taxes, or tuition liabilities of the spouse receiving the alimony, medical and dental expenses, or attorney's fees made under the terms of the divorce or separation instrument are qualifying payments. Payments of life insurance premiums can also qualify as alimony as long as the payee-spouse owns the policy.

Example. Under your divorce decree, you must pay your former spouse's medical and dental expenses. If the payments otherwise qualify as alimony, you can deduct them as alimony on your return. Your former spouse must report them as alimony received and can include them in figuring deductible medical expenses.

However, payments to maintain property owned by the spouse paying the alimony, but used by the spouse receiving the alimony, do not qualify as alimony even if they are made under the terms of the divorce or separation instrument.

Comment. The treatment of payments made with respect to jointly owned property is determined based on the spouses' proportional interests. However, as the owner of the property, the payer-spouse can take itemized deduction for mortgage interest and real estate taxes.

Cash payments to a third party on behalf of the payee-spouse also qualify if they are made at the payee's written

request. For example, a cash payment to a charitable organization at the request of the payee-spouse qualifies as an alimony payment if the payment is made pursuant to the payee-spouse's written request, consent, or ratification.

CHILD SUPPORT

Child support payments are not deductible by the payer-spouse or taxable to the payee-spouse.

Caution. As with alimony, merely labeling payments as child support is not enough. There are many requirements that must be met.

Child support payments are payments fixed by the terms of the divorce or separation instrument as a sum payable for the support of the child. A fixed payment may be reduced upon the happening of a contingency specified in the instrument relating to the child, such as attaining a certain age, marrying, dying, or leaving school. Most child support agreements end when the child reaches age 21, although frequently provision is made to cover college costs. Special terms are also provided for children who cannot fully care for themselves.

Dependency exemption. Closely related to child support is the issue of who gets to claim the dependency exemption for the child. Generally, the parent who has custody of the child gets to claim the exemption. However, the custodial

parent can release the exemption to the noncustodial parent.

Caution. Release of the dependency exemption to the noncustodial parent must be done by an express waiver by the custodial parent, usually by completing IRS Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents. Some divorce and separation agreements may not sufficiently release the exemption to the noncustodial parent, for IRS purposes, because they typically provide that the noncustodial parent “may” claim the exemption for designated tax years, not that the custodial parent will not claim it.

Caution. Many times when one spouse is making payments to the other spouse in connection with a divorce, the alimony and child support are paid monthly in one check. You should note, however, that payment in this manner does not make the child support qualify as deductible alimony or separate maintenance payment. The portion of the payment representing child support is not deductible by the payer or includable in the income of the spouse receiving it to the extent the payment under the instrument is fixed or treated as fixed as support for the payer-spouse’s children. Moreover, if the amount paid is less than the payer’s total spousal and child support obligations, the payments are first allocated to child support and then to spousal support.

Payments for the benefit of persons other than the payer-spouse’s children

are not child support. They may be treated as alimony if they meet the alimony requirements and the parties do not state in the instrument that they are not deductible or includable in income. Step-children who were not formally adopted may fall into this category.

QUALIFIED DOMESTIC RELATIONS ORDER (QDRO)

A QDRO is a type of court order that creates or recognizes the existence of a former spouse’s right to receive all or a portion of the benefits payable to the plan participant-spouse. A QDRO is a judgment, decree, or court order (including an approved property settlement agreement) issued under domestic relations law that:

- Relates to the rights of someone other than a participant to receive benefits from a qualified retirement plan or a tax-sheltered annuity;



- Relates to payment of child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent of the participant; and
- Specifies the amount or portion of the participant's benefits to be paid to the participant's spouse, former spouse, child, or dependent.

Plan distributions under a QDRO.

Any amount actually distributed to a distributee under a qualified plan is taxable to the distributee in the year of distribution. Thus, a spouse or former spouse who receives plan distributions under a QDRO is taxed on those distributions. This is the case even if the QDRO provides that all taxes that are due on distributions under the QDRO are to be paid by the participant.

Retirement plan benefits paid without a QDRO

Rather than having the retirement benefits paid directly from the plan as they are under a QDRO, the couple may prefer to enter a cash settlement with the spouse participating in the retirement plan making direct cash payments to the other spouse in lieu of any marital rights in the plan benefits or merely as part of a property settlement.

Individual Retirement Arrangements (IRAs)

Divorce and separation can have an impact on traditional IRAs and other

retirement plans. Some of the effects on individual retirement arrangements, other than Roth or simple IRAs, are:

- ***Spousal IRA.*** If you get a final decree of divorce or separate maintenance by the end of your tax year, you cannot deduct contributions you make to your former spouse's traditional IRA. You can only deduct contributions to your own traditional IRA.
- ***IRA transferred as a result of divorce.*** The transfer of all or part of your interest in a traditional IRA to your spouse or former spouse, under a decree of divorce or separate maintenance or a written instrument incident to the decree, is not considered a taxable transfer. Starting with the date of the transfer, the traditional IRA interest transferred is treated as your spouse's or former spouse's traditional IRA.
- ***IRA contribution and deduction limits.*** All taxable alimony received by the recipient-spouse under a decree of divorce or separate maintenance is counted as compensation for purposes of determining the recipient spouse's contribution and deduction limits on his or her traditional IRAs.

Property settlements

No gain or loss is recognized when an individual transfers property to a spouse or former spouse incident to a divorce. Property settlements – whether in a lump sum or installments - even though required by the divorce decree or other written agreement, do not qualify as alimony.

This nonrecognition rule also applies regardless of whether the transfer of property is for the relinquishment of marital rights or the cancellation of debt. Moreover, it applies regardless of whether the property transferred was owned separately or together during the marriage.

Comment. An exception to this rule applies to treat a transfer of property in trust for a former spouse as a sale to the extent that the liabilities on the property exceed its basis.

Incident to divorce

Property transfers are incident to divorce if they occur within one year after the date of divorce, or are related to the end of the marriage. A transfer is related to the end of the marriage if the property is transferred under a divorce or separation instrument within six years after the divorce date.

Caution. Transfers of property to or from a third party on behalf of a former spouse qualify for nonrecognition treatment in some cases. Nonrecognition treatment does not apply when the spouse or former spouse receiving the property is a nonresident alien. Gain or loss is recognized on those transfers.

Comment. The nonrecognition rules apply to all types of transfers, including transfers of stock options, deferred compensation, and other intangible property.

Tax impact

Although property settlements are generally tax-free to both parties, this does not mean that taxes are not important in property settlements. While the property settlement itself ordinarily is not taxable, who gets what property can greatly affect either spouse's potential future taxes if the property received is later sold. This is because of the rules regarding basis. The spouse receiving the property transferred incident to a divorce takes a carryover basis equal to the adjusted basis of the property in the hands of the transferor-spouse immediately before the transfer.

Example. A vacation home worth \$350,000 was purchased a few years ago for \$300,000 and \$350,000 of stock also was purchased several years ago for \$150,000. The spouse receiving the stock would have a \$200,000

gain (\$350,000 less basis of \$150,000) on an immediate sale, whereas a sale of the vacation property would result in only a \$50,000 gain (\$350,000 less \$300,000).

Distinguishing between property settlements and alimony

Generally, if a payment meets all alimony requirements and restrictions, it automatically qualifies as an alimony payment and is deductible by the payer and includable in income by the payee, without any approval required from the IRS.

Recapture rule. To ensure that payments deducted as alimony are not actually disguised property settlements, special “front-loading” rules provide for the recapture of excess alimony payments as income. The recapture rule comes into play when alimony payments are reduced or terminated during the first three years.

Excess alimony payments are recaptured in the payer-spouse’s tax year beginning in the third post-separation year by requiring the payer-spouse to include the excess in income that year. The payee-spouse, who previously included the payments in income as alimony, may deduct the recaptured amount from gross income in the payee’s tax year beginning in the third post-separation year.



Jointly-owned businesses

Complications and tax traps can occur when a jointly-owned business is to be transferred to one spouse in connection with a divorce.

Caution. The importance of properly structuring the transfer of a business owned with your spouse cannot be overstressed. When one spouse winds up with the family business as the result of a divorce, who bears the tax cost and what that tax cost will be is completely dependent on how the transaction is accomplished.

Buyouts

Frequently, when a jointly-owned business is involved, the first place a couple looks to obtain funds for a buyout is the business itself. In that case, one spouse’s stock will be redeemed by the company. A redemption of an individual’s entire stock interest in the business can be fairly straightforward – the difference between the amount paid by the company and the individual’s

stock basis (usually what the individual originally paid for the stock) is a capital gain or loss. However, complications arise with divorce-related redemptions.

Caution. In a buyout, the spouse who keeps the company may face a big tax bill on account of the redemption of the other spouse's stock. On the other hand, the redeemed spouse may be able to escape paying any tax on the redemption.

Example. One spouse gets the primary residence and the other spouse gets the vacation home and investment property. Neither spouse is treated as having made a taxable sale to the other spouse. But when the spouse being bought-out of a family business is having his or her shares redeemed by the company in exchange for cash from it, the spouses should be more cautious. For example, one spouse who was bought out (the wife) got a court to agree that she did not have to pay tax on the redemption.

- **Planning tip.** If company funds absolutely have to be tapped, the spouse who will get the business should insist that the divorce agreement not obligate the other spouse to transfer his or her shares. There can, however, be a separate redemption agreement between the spouse who is being bought-out and the company. If these steps are taken, the gain on the redemption will be taxed to the redeemed spouse who will have cash from the redemption to pay the tax.

Home sales

Homeowners may generally exclude from income up to \$250,000 of gain realized on the sale or exchange of a residence under Code Sec. 121. The exclusion increases to \$500,000 for joint filers. Ownership and use requirements must be met. For example, the taxpayer must have owned and used the property as a principal residence for a total of two years during the five-year period before the sale. Moreover, there are exceptions for periods of nonqualifying use.

If property is transferred to a spouse or former spouse incident to divorce, the period the transferee spouse owns the property includes the period the property was owned by the transferor spouse. A transfer for these purposes is one that qualifies for the nonrecognition rule applicable to transfers between spouses or between former spouses incident to a divorce.

In addition, and only for purposes of the gain exclusion, a taxpayer is treated as using property as his principal residence during any period that the taxpayer's spouse or former spouse is granted actual use of the property under an instrument of divorce or separation.

Example. Jim and Tina divorced. Their marital home had been in Jim's family for three generations. Rather than sell the house and split the proceeds after the end of the

marriage, Jim buys a house with a value of about half of the marital home and transfers it to Tina within one year of the divorce. This transfer results in no gain or loss to Jim, and Tina takes a carryover basis.

Deductibility of legal and accounting expenses

Many cases have dealt with whether legal and accounting expenses incurred in connection with divorce, property settlement, and alimony proceedings are deductible. To be deductible, any such expenses must be related to the taxpayer's profit-seeking activities. Personal expenses are not deductible. The standard adopted by the Supreme Court for determining whether legal costs are personal or business related, and hence deductible, is the origin and character of the claim.

Only if the claim arises in connection with your profit-seeking activities are legal costs deductible. The potential consequences on your income-producing property from failing to defend or prosecute the claim are irrelevant. Any motives or purposes you incur in undertaking or defending any litigation are also irrelevant.

Divorce and separation. In applying the origin and character of the claim standard to marital litigation, claims asserted by a spouse in a divorce action are almost always found to arise from the

marital relationship rather than a profit-seeking activity. Therefore, legal fees and other costs connected with a divorce, separation or decree for support are generally not deductible.

"So what's deductible?"

Legal and accounting costs paid specifically to produce or collect taxable alimony are deductible. The portion of legal fees in a divorce that pertains solely to advice on tax matters is also deductible.

Fees expended to secure the right to another non-alimony form of income that arises as part of a divorce action are deductible. For example, the portion of legal fees incurred in a divorce to obtain the right of possession (as distinct from ownership), or the right to participate in the income from business property is deductible.

Finally, legal fees incurred as part of a divorce action in an attempt to obtain an accounting of joint venture profits or a share in the profits of a corporation are also deductible.

Innocent spouse relief

If you file a joint return with your spouse, you are both jointly and severally liable for the entire tax due, including penalties and interest, even if you later divorce. This is the case, even if one spouse is unaware of inaccuracies on the return.

However, under the innocent spouse relief rules, a spouse may be relieved of responsibility for an understatement of tax if certain conditions are satisfied. Innocent spouse relief is provided by the IRS because sometimes the circumstances are such that it would be unfair and inequitable to hold one spouse liable for a tax liability generally created by the other spouse.

Comment. The Tax Court has jurisdiction to review IRS innocent spouse determinations and, based on case law, has become more sympathetic to the requesting spouse's plight in recent years.

There are three types of innocent spouse relief: general relief, separate liability relief, and equitable innocent spouse relief.

General innocent spouse relief. General innocent spouse relief is available if the following conditions are met:

- The couple filed a joint return;
- An understatement of tax results from erroneous tax items attributable to the non-requesting spouse;
- The requesting spouse did not know or have reason to know of the understatement when he or she signed the return;
- It is inequitable to hold the requesting spouse liable for the deficiency; and
- The requesting spouse elects innocent spouse relief no later than 2 years after the IRS begins collection

activities and provides the spouse with notice of innocent spouse rights.

Separate liability relief. Separate liability relief relieves the requesting spouse from tax liabilities arising from tax items allocable to the nonrequesting spouse. It can be elected if:

- The couple is no longer married, is legally separated, or did not share the same household at any time during the 12 months preceding the election; and
- The requesting spouse did not have actual knowledge of the item giving rise to the couple's deficiency at the time he or she signed the joint return.

Equitable relief. Equitable innocent spouse relief from joint and several liability is available when, taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable for any unpaid tax or any deficiency, and the requesting spouse does not qualify for general innocent spouse relief or separate liability relief.

In addition to deficiencies arising from an understatement of tax, equitable relief is also available for underpayments of tax shown due on the return.

Comment. General innocent spouse relief and separate liability relief are available only with respect to tax deficiencies, not underpayments.

The IRS may grant equitable relief to a spouse who does not meet other requirements for relief if it would be inequitable to hold him or her liable for any unpaid tax or deficiency.

To make this determination, the IRS considers the following facts and circumstances:

- The requesting spouse's current marital status;
- Abuse experienced during the marriage;
- Reasonable belief that the tax was going to be paid;
- Current financial hardship;
- Knowledge or reason to know of the non-requesting spouse's deficiency or underpayment;
- The non-requesting spouse's legal obligation to pay the liability;
- Significant benefit from the deficiency or underpayment; and
- Compliance with income tax laws.

Comment. A requesting spouse seeking equitable relief must file Form 8857, Request for Innocent Spouse Relief (and Separation of Liability, and Equitable Relief), or other similar statement.

Caution. Community property states (Arizona, California, Idaho, New Mexico, Texas, etc.) generally require you to allocate community income and expenses equally between both spouses. However, they are not taken into account in determining whether an item belongs to you or your spouse (or former spouse) for purposes of requesting any relief from liability.

CONCLUSION

Divorce has many tax consequences that must not be ignored or put aside because of the emotion of the moment. The decision to terminate a marriage also ends an economic partnership. Your tax status changes after divorce and you have new tax responsibilities and rights.

These have important and often subtle tax implications. Your tax advisor will help protect your interests and minimize your tax liability to the extent allowed by law.