TAX GUIDE
for divorce

The statistics on divorce vary, depending on whose figures you use, but somewhere between 30% and 50% of marriages end in divorce.

Divorce can significantly affect the tax situation of the parties involved, and only careful planning with the assistance of an experienced tax advisor will minimize the tax cost of a divorce. This brief review shows how far-reaching the tax implications of divorce can be.

PROPERTY settlement

A transfer of property as part of a divorce settlement is not subject to income tax. However, the basis (the cost for determining taxable gain) of the property transfers with the property and may create income tax for the spouse who receives the property if the property is later sold.

To illustrate, if a couple has $100,000 of mutual funds and a $100,000 bank account, it would not be an equal split to have each spouse take one asset. The $100,000 bank account has no income tax consequences connected with it. But if the mutual funds have a tax basis (cost) of $30,000, the person who gets them in the settlement could pay tax on $70,000 of gain if the funds are later sold.

When dividing property at the time of divorce, this potential tax liability should be factored into the valuation of various assets.

ALIMONY payments

Alimony is deductible by the person paying it and taxable to the person receiving it. Any portion of a payment that is specified as support for the couple's minor children is not considered alimony.

In order to ensure that the payments deducted as alimony are not disguised property settlements (which are nondeductible), the tax regulations provide certain limitations on the term of payment and the fluctuation in the amount of annual payments.

DEPENDENCY exemption

The law states that the custodial parent is entitled to the dependency exemption for children unless that parent waives the right to the exemption in writing.

The parent who maintains a home for a dependent child for more than half of the year may still qualify for the earned income credit, the child care credit, and the head of household rate even if that parent has waived the dependency exemption to the non-custodial parent.

The parent who pays the child's medical expenses may claim them along with his or her own, regardless of which parent gets the dependency exemption.

CHILD support

Payments made for child support are not deductible by the spouse paying them, nor are they income to the spouse receiving them.

Child support may not be disguised as alimony. Payments not designated as child support will be reclassified as child support if they are to be reduced by a certain event in the child's life (i.e., when the child reaches a certain age, graduates, leaves home, etc.).

SALE of residence

Once very restrictive, the tax rules governing the sale of personal residences in a divorce are now such that most sales will be tax-free. The law exempts from taxation profits on the sale of your home of up to $250,000 for singles and $500,000 for couples. To qualify for the exemption, you must have owned the home and occupied it as your principal residence for at least two of the five years prior to the sale.

Getting details on how the rules will apply to any home sale connected with divorce is advisable.

DEDUCTIBLE fees

The cost of getting a divorce is not deductible. However, legal fees that relate specifically to a property settlement may be added to the basis of the property. Fees that you pay for obtaining alimony and for tax advice in connection with the divorce are deductible as miscellaneous itemized deductions.

RETIREMENT accounts

Dividing up retirement benefits also presents tax challenges in a divorce. You can split up the benefits of a qualified retirement plan without tax consequences if you obtain a qualified domestic relations order (QDRO). But even then, the rules are complex and the consequences of an error can be severe. Other retirement benefits, such as IRAs, can be transferred without a QDRO, but the transfer must still be carefully structured to avoid unplanned tax results.

WILLS and estate planning

Any change in marital status should be followed immediately by a review of wills and estate plans. This is especially important where sizable assets, children, or a family business is involved. Also check all insurance policies as well as your IRA and other pension plans. Change coverage and beneficiaries as appropriate.

The information in this brochure is of a general nature and should not be acted upon without further details and/or professional guidance. For assistance, please contact our office.

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