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## QUICK REFERENCE GUIDE - DIVORCE RELATED TAX MATTERS

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### TAX ISSUES RELATED TO DIVORCE

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TAX CONSEQUENCES OF DIVORCE: Under IRC §1041(a), no gain or loss is recognized on transfers if incident to divorce. "Incident to Divorce" if :

- Occurs within one year after the divorce, or
- Is related to the ending of the marriage meaning:
  - Pursuant to a divorce or separation instrument, and
  - Occurs within six years after the date which the marriage ended.

Property acquired after the marriage ends qualifies for 1041 treatment if all other requirements are met.

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### COSTS OF GETTING DIVORCED

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Legal and professional fees as well as court costs related to getting a divorce are generally not deductible. Payment of former spouse's attorney or professional fees also not deductible, unless they meet the requirements of deductible alimony (§71 payments).

#### Nondeductible costs:

- Expenses paid in arranging child custody and support.
- Expenses paid in arriving at a financial settlement and retaining income-producing property.

#### Deductible costs (legal or accounting):

- Fees paid for tax advice related to a divorce.
- Fees paid to determine or collect alimony.
- Fees paid to determine estate tax consequences of a property settlement.
- Fees paid to professionals such as appraisers and actuaries if the services were performed to determine the correct amount of tax or to assist in obtaining alimony.
- Obtain deductibility breakdown from attorney or accountant.

The parties frequently are in need of cash to pay attorney fees, experts, etc. In the absence of other sources, consider using cash value in life insurance policies, or transfer funds (including tax consequences) from retirement plans to other spouse to be used to pay joint debts or to make cash available to either or both.

#### Consideration of Income vs. Non-incoming Producing Assets

Income producing assets:

- Rentals
- Royalties
- Business interests
- Receivables

Non-income producing assets:

- Residence
  - Vacation home
  - Investment land
  - Personal property
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### ALIMONY VS. CHILD SUPPORT

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Qualifications of Alimony - §71(b)

- Cash payments or third party payments required under divorce or separation instrument
- Payments must be required by written instrument
- Instrument may not designate the payment 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 the recipient
- Parties may not file a joint return

#### Payments that do not qualify as alimony

Child support  
Non cash transfers  
Payments that are the spouse's part of community property income  
Payments for use of property  
Payments to keep up the payer's property

#### Recapture of Alimony

Recapture rules may apply if there is a decrease or termination of alimony during the first three calendar years of payment. Recapture rules apply if alimony paid in the second or third calendar year is \$15,000 less than in the prior year.

May occur for:

- Failure to make timely payments
- Change in divorce or separation agreement
- Reduction in spouse's support needs
- Reduction in payer's ability to provide support

Consider Option to Treat as "Not Alimony" when

- Payer has little or no gross income
- Payer's other deductions exceed gross income

Child Support Before Alimony – If obligated to pay both alimony and child support, but pays less than monthly amount due, payments first applied to satisfy the child support obligation. Child support obligation must be met before any amount of alimony is deductible.

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**PERSONAL RESIDENCE**

Capital gain exclusion of \$250,000 (single) and \$500,000 (married) for sale of principal residence. "Principal residence" – home where you lived for any two of the last five years. Consider when to sell the House: before or after the divorce. Risk: waiting too long after party moves out of the home before their interest gets sold. Effectively, home must be sold within three years after departing spouse moves out for exclusion to apply to the departing spouse. If remaining spouse has the right to live in the home pursuant to divorce or separation agreement, the remaining spouse's residence in the house will be counted as the departing spouse's residence for purposes of calculating the two year requirement.

**FILING STATUS**

Marital status for tax filing is set as of the last day of the year – December 31. If you are divorced as of December 31, you must file as single taxpayers (or head of household for that year, even if you lived together as a married couple more than half the year. If you are married as of December 31, and you and your spouse lived in the same household and were not legally separated, you must file as married – either joint or separate returns.

Caution: Filing separate and the use of standard / itemized deduction. The first one to file establishes the requirement of the other to do the same.

Caution: Joint return = Joint liability no matter what divorce instrument says.

Marital status at 12/31	Legally separated	Living together in same household 7/1 thru 12/31	Dependent child or other dependent living in home	Tax filing status available for year
Married	No	Yes	N/A	MFJ, MFS
Married	Yes	No	No	S
Married	Yes	No	Yes	S, HOH
Married	Yes	No	Yes	MFJ, MFS, HOH
Divorced	No	Yes	No	S
Divorced	N/A	No	No	S
Divorced	N/A	No	Yes	HOH
Divorced	N/A	Yes	Yes	HOH

MFJ - Married filing jointly

S - Single

MFS - Married filing separately

HOH - Head of Household

You may be able to file as head of household, even

if you were legally married on December 31. To qualify as Head of Household, you must be considered "unmarried" on December 31 and you must have paid more than half the cost of keeping up a home for the year for a child or other qualifying person for whom you or the other parent is entitled to claim the tax exemption lived with you in the home for more than half the year.

\*\* You are considered unmarried if you were legally separated on December 31 or if your spouse did not live in your home for the last six-months of the year.

**CHILDREN / DEPENDENCY EXEMPTIONS**

Custodial parent is entitled to the dependency exemption. Parents, together or separately, must provide at least one-half of the child's support.

Two exceptions to the general rule that the custodial parent is entitled to the dependency exemption.

1. A multiple support agreement is in place - §152(d)(3)
2. The custodial parent relinquishes the rights to the exemption (either annually or permanently) - §152(e)(2)(A).

	Age Requirement	Qualifying Child Relationship	Residence	Support	Citizenship
Dependency Exemption	<19, or 24 if full time student	Son or Daughter  Stepson/Stepdaughter	Child resides with the taxpayer for > one-half of the year.  Exceptions include temporary absences due to education, illness, vacation or military service.	Qualifying child cannot provide more than one-half of their own support for the year.	A citizen or resident of the U.S.  A citizen or resident of a country contiguous to the
Child Tax Credit	<17	Descendents of sons, daughters, stepsons, or stepdaughters			
Dependent Care	<13	Individuals whom are legally adopted or a foster child placed with the taxpayer by an authorized agency or by court decree, order or judgment.			
Tuition Credits or Deductions	<19, or 24 if full time student.				
Earned Income Credit	<19, or 24 if full time student.		Child must have the same principal place of abode in the U.S. as the taxpayer for > one-half of the year.	Support test does not apply for EIC	

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### MORTGAGE INTEREST AND REAL ESTATE TAXES

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In General - The joint owner who makes the payment is entitled to the deduction. If payments are made out of a joint account, there is a rebuttable presumption that the payment is made 50% by each party. Example: If Husband (H) pays 70% of the payment and Wife (W) pays 30%, the deductible portion of the payment is allocated in the same proportion.

In a Divorce Context: If payments are not made pursuant to a divorce or separation instrument - General rules apply

If the home is jointly owned and payments are made by H, the non-occupant, directly to the mortgagee:

- ½ of the qualifying interest and real estate taxes are deductible by H.
- ½ qualifies as alimony provided the requirements of Section 71 are met. (accordingly, this is deductible by H and taxable to W and W may deduct her ½ of the mortgage interest and real estate taxes)

If the home is solely owned by W and H is still obligated on the mortgage:

- The treatment of the interest deduction is the same as if jointly owned, provided a minor child of the marriage resides in the home with W.
- H cannot deduct any of the real estate taxes however, since he has no ownership interest.

If the home is solely owned by H (even though W may be living there with or without children of the marriage):

If H makes the payments:

- H would deduct 100% of the mortgage interest and taxes.
- None of the payments would qualify as alimony to W.

If W makes the payments:

- May be taxable to H as alimony who would then be able to deduct 100% of the interest and taxes.

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### RETIREMENT PLANS AND IRAS

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Qualified Retirement Plans:

- Qualified Domestic Order (QDRO) / Eligible Domestic Relations Order (EDRO) – Court can allocate an interest in a qualified retirement plan to a non-employee spouse (alternate payee).
- To qualify as a QDRO, funds must be distributed to the alternate payee or his or her designee directly from the plan.
- Payments made as a result of a QDRO to the alternate payee have no effect on the participant in the pension plan.
- Benefit taxed to the alternate payee when payments received (not subject to 10% early withdrawal penalty) or may be rolled over tax-free into an IRA or other qualified retirement plan.
- DROs can be very complicated and costly to set up; A specialist is typically hired to do them.
- Alternate Solution – Borrowing from retirement plan for property settlement payment.
- IRA transfers pursuant to a divorce or separation instrument are not taxable. Methods of transfers include:
  - Changing the name on the account, and
  - Making a direct trustee-to-trustee transfer of IRA assets.
- Divorce or separation instrument should state that the transfer is intended to be tax free under the IRC §408(d)(6).
- DROs do not apply to IRAs
- Spousal IRA Contribution - If final decree is obtained by the end of the tax year, a spouse cannot deduct contributions made to a former spouse's IRA.
- Withdrawing funds from an IRA to satisfy a divorce judgment cause the IRA owner to be taxed on the distribution, and if applicable, imposition of the 10% early withdrawal penalty.
- 10% early withdrawal penalty can be avoided if withdrawals are “annuitized” over the recipient's life expectancy. Once a series of withdrawals commence, it must continue at least until the IRA owner reaches 59 ½.
- Taxable alimony received is treated as compensation for purposes of the IRA contribution and deduction limits.

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### STOCK OPTIONS AND DEFERRED COMPENSATION

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Equitable distribution of stock options and deferred compensation in divorce:

Revenue Ruling 2002-22

1. A taxpayer who transfers an interest in non-statutory stock options and non-qualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer.
2. The former spouse, and not the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

The same conclusion would apply in a case in which an employee transfers a statutory stock option (such as those governed by §422 or 423(b)) contrary to its terms to a spouse or former spouse in connection with divorce. The option would be disqualified as a statutory stock option, see §422(b)(5) and 423(b)(9), and treated in the same manner as other non-statutory stock options. Section 424(c)(4), which provides that a §1041(a) transfer of stock acquired on the exercise of a statutory stock option is not a disqualifying disposition, does not apply to a transfer of the stock option.

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This ruling does not apply to transfers of property between spouses other than in connection with divorce. This ruling also does not apply to transfers of non-statutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer.

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### TRANSFERRING/REDEEMING STOCK OF A CLOSELY HELD COMPANY

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Often there is insufficient cash or other property to satisfy a division of marital assets when there is a closely-held family corporation in the marital estate. When the desired result is the sole ownership of the business by one of the parties, the transfer of stock ownership for cash in divorce may involve two steps:

1. Transfer of stock from one spouse to the other, followed by
2. The recipient spouse transferring the shares to the corporation in redemption of all the shares received from the soon to be ex-spouse.

Carryover rules related to basis and holding period of the transferred shares apply in determining gain on the redemption. This can be a tax trap for the unsuspecting spouse. Structured properly, redemption at capital gain rates to the non-owner spouse can be accomplished. Structured improperly, the spouse retaining the business can be deemed to have received a constructive dividend (currently taxed at the same rate as capital gains, but historically has been at ordinary income tax rates), albeit while not receiving any cash to pay the tax. Internal Revenue Service Reg. 1.1041-2 indicates that if a divorce or separation agreement between the spouses or former spouses includes the following, the transferor spouse will be taxable.

- Section (c)(1)(i) Both spouses or former spouses intend for the redemption to be treated, for federal income tax purposes, as a redemption distribution to the transferor spouse; and
- Section (c)(1)(ii) such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is subject to the redemption.

Section (c)(2) relates to situations in which the non-transferor spouse will be taxable including circumstances under which the non-transferor spouse will be deemed to have received a constructive distribution from the corporation followed by the deemed transfer of cash to the transferor spouse in redemption of his or her stock. If the divorce or separation agreement sets forth the following agreements of the parties, the transfer will be treated as a constructive distribution to the non-transferor spouse:

- "(i) Both spouses or former spouses intend for the redemption to be treated, for federal income tax purposes, as resulting in a constructive distribution to the non-transferor spouse; and
- (ii) such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other distribution of the stock that is the subject of the redemption."

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### INNOCENT SPOUSE AND SEPARATE LIABILITY RELIEF

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Relief from tax liability from the IRS is available to qualified individuals in three alternatives – IRC §6015.

1. Innocent Spouse – IRC §6015(b) and IRS Pub. 971
2. Separation of Liability – IRC §6015(c)
3. Equitable Relief – IRC §6015(f) and Rev. Proc. 2003-61

Factors considered for relief by the IRS and Courts (Rev. Proc. 2000-15 Sec. 4.03)

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| <ul style="list-style-type: none"><li>• Knowledge</li><li>• Economic hardship</li><li>• Significant benefit to the person seeking innocent spouse relief</li><li>• Later compliance with Federal tax laws</li></ul> | <ul style="list-style-type: none"><li>• Tax liability attributable to non-requesting spouse</li><li>• Non-requesting spouse responsibility for the tax pursuant to the divorce decree</li><li>• Marital status</li><li>• Spousal abuse</li></ul> |
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Burden of proof for relief is on the taxpayer - §6015(c)(2) and *Shafman v. United States* 267 B.R. 709 (2001).

Joint tax returns signed under duress are not joint returns – Reg. §1.6013-4(d).

IRS tax form for requesting relief under any of the three provisions – Form 8857 (June 2007).

Separate liability election requires

1. no longer married or
2. legally separated, or
3. not a member of the same household at any time during the 12 month period prior to electing separate liability

(Filing the divorce complaint is not legal separation – *Vetrano vs. Commissioner*, 116 T.C. 272, 282 (2001).