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# **Divorce And Separation**

**GAINER DONNELLY & DESROCHES**


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## Divorce And Separation

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, reality is that the way you structure any payments made “incident to” separation and divorce—regardless of whether they are made pursuant to an agreement you work out with your spouse or a court-ordered settlement—can have a tremendous impact on your income tax status 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.

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This guide will help you understand the tax consequences of certain payments that may be arranged as part of a divorce settlement as well as certain other tax issues arising in the context of a divorce or separation. The areas that will be discussed include:

- Alimony;
- Qualified Domestic Relations Orders (QDROs);
- Individual Retirement Arrangements (IRAs);
- Child Support;
- Property Settlements;
- Jointly Owned Businesses; and
- Innocent Spouse Relief.

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### 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 (also sometimes referred to as property settlements);
- Taxable alimony or separate maintenance payments; and
- Nontaxable child support payments.

Sometimes it can be unclear whether a particular payment or transfer of property is alimony or child support. Likewise, it is also sometimes difficult to determine whether certain payments or transfers of property are alimony or a nontaxable property transfer. Since the tax treatment of each type of payment is different, it is important to understand the characteristics of each type from the perspective of the IRS. The material that follows examines the required characteristics of each type of payment or property transfer.

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### 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 or separate maintenance payments are deductible by the payer spouse and is taxed to the payee spouse receiving the alimony unless both agree that it will be tax-free to the recipient and nondeductible by the payer.

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

**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 (since 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.

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Payments qualify as alimony only if:

- The payments are in cash;
- They are received by or on behalf of a spouse under a divorce or separation instrument;

- Spouses who are legally separated under a decree of divorce or separate maintenance are not members of the same household;
- No liability to make payments (or substitute payments) after the recipient's death;
- The parties do not file a joint return with each other; and
- The payments are not child support.

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 and your spouse agrees to "share" some of the savings with you.

**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'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.

### **Payments 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 if they are required by the divorce or separation instrument, and the payments meet all other requirements to be classified as alimony. For example, 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.

*Example.* Under your divorce decree, you must pay your former spouse's medical and dental expenses. If the payments otherwise qualify, 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.

Payments of life insurance premiums can also qualify as alimony as long as the payee-spouse owns the policy. However, payments to maintain property that is owned by the spouse who is paying the alimony, but is 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.

*Example.* Nonqualifying alimony payments include mortgage payments or real estate tax payments on a house owned by the payer-spouse or insurance premiums on a life policy owned by the payer-spouse. The treatment of payments made with respect to jointly owned property is determined based on the spouses' proportional interests.

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.

### **Qualified Domestic Relations Order (QDRO)**

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.

### **Retirement Plan Benefits Paid Without 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.

10 The IRS has privately ruled that installment payments equal to half the value of an ex-spouse's employment benefits were not taxable because they were made to divide property owned by the spouses at the time of the divorce.

**Caution.** In the absence of a QDRO, this arrangement may lead to income tax on the distribution to the participating spouse.

**Example.** An ex-husband was taxed on a distribution from a pension plan even though he was required by a final divorce judgment to transfer cash to his ex-wife equal to one half of the pre-tax value of his pension account. The court emphasized that the tax was not on any transfer of the wife's rights in the pension resulting from the divorce decree nor was it on the cash transfer to the wife; rather, the tax was on the income the husband received from the pension plan.

### **Individual Retirement Arrangements (IRAs)**

Divorce and separation can have an impact on traditional IRAs. Some of the effects on traditional 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

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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.

### Child Support

Child support payments are not deductible or taxable.

*Caution.* As with alimony, merely labeling payments as child support is not enough. Many requirements 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.

Closely related to child support is the issue of who gets to claim the dependency exemption for the child. In general, it goes to the parent who has custody of the child. 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 explicit waiver by the custodial parent, usually by completing IRS Form 8332. Some divorce and separation agreements may not be valid for IRS purposes because they typically say 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.

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.

In allocating payments between alimony and child support, if the total monthly payments made are less than the total amount required, payments are treated first as child support.

### **Property Settlements**

No gain or loss is recognized when an individual transfers property to a spouse or former spouse incident to a divorce.

Also, 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 rule is meant to apply to property settlements incident to divorce and it is not elective, meaning that it applies automatically. This rule applies regardless of whether the transfer of property is for the relinquishment of marital rights or the cancellation of indebtedness; it also applies regardless of whether the property transferred was owned separately or together during the marriage.

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 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 and 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.

### **Tax impact**

Since property settlements generally are tax-free to both parties, does that mean taxes are not important in property settlements? Not at all. 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 by the payee, without any approval required from the IRS.

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



**Planning tip.** Even if you plan to retain assets, such as a house, you should carefully consider basis when negotiating for specific assets because circumstances may change and property may have to be sold sooner than you may think.

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 will be transferred to one spouse in connection with a divorce.

**Caution.** The importance of properly structuring the transfer of the business owned with your spouse cannot be overestimated. 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.

## Buyout

Frequently, when a jointly-owned business is involved, the first place a couple looks for funds for the buyout is the corporation itself. In other words, one spouse's stock will be redeemed by the corporation. Normally, a redemption of an individual's entire stock interest is 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 corporation. 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.

## 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.

In applying these principles to divorce and separation matters, the origin of the claim standard overturned earlier cases that focused on the manner in which marital claims would be satisfied, and that allowed a deduction for legal fees of contesting a divorce if the property claims threatened the destruction of the taxpayer's capacity to earn income.

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. Finally, fees expended to secure the right to another non-alimony form of income that arises as part of a divorce action are deductible. Thus, the portion of legal fees incurred in a divorce spent to obtain the right of possession (as distinct from ownership) or the right to participate in the income from business property are deductible. 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, you and your spouse are jointly and severally liable for the tax and any interest or penalties due even if you later divorce. This is so, even when one spouse is unaware of an inaccuracy. However, under the innocent spouse rule, a spouse may be relieved of responsibility for an understatement of tax if certain conditions are satisfied.

Innocent spouse relief maybe available if:

- You filed a joint return;
- An understatement of tax results from erroneous items

- You did not know or have reason to know of the understatement when you signed the return; and
- It is inequitable to hold you liable for the deficiency; and

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.

The IRS considers

- Current marital status;
- Abuse experienced during the marriage;
- Reasonable belief that the tax was going to be paid;
- Current financial hardship.

**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. How extensive these are largely depends on how you structure your divorce. Sometimes, your input is limited. In other situations, divorcing spouses cooperate and craft mutually tax advantageous agreements.

You need to plan for:

- Alimony;
- Qualified Domestic Relations Orders (QDROs);
- Individual Retirement Arrangements (IRAs);
- Child Support;
- Property Settlements;
- Jointly Owned Businesses; and
- Innocent Spouse Relief.

These have important and often subtle tax implications. Your tax advisor will help protect your interests and minimize your tax liability.