The Tax Aspects of Divorce

What every couple should know

By Robert D. Flach

With every major life event, it's important to consider the current and future tax consequences. Divorce is no exception. So why don't more couples have a tax professional carefully review a divorce agreement and property settlement *before* it is finalized?

The Basics

- Filing status is determined by marital status on the last day of the year. If you are legally divorced on December 31, you'll file your return for that year as either Single or Head of Household. If the divorce is not finalized and you are still legally married on December 31, you generally must file as either Married Filing Jointly or Married Filing Separately. If a dependent child is involved, the custodial spouse may be able to file as Head of Household.
- Alimony is allowed as an "above-the-line" deduction by the person paying it and must be claimed as taxable income by the person receiving it. Child support is neither deductible nor taxable. Even though a required annual payment is described as "alimony" in the divorce decree, if the payment is reduced or stops on any event relating to a child (i.e., reaching a certain age, graduating from college, marrying, dying, earning a certain amount of income), that amount is considered to be child support and therefore not deductible.
- Generally the cost basis of an asset (and its holding period) does not change as a result of divorce. If, prior to divorcing, a couple owns a personal residence with a cost basis of $200,000, the cost basis for the spouse who receives title to the property as a result of the divorce remains $200,000 regardless of the market value of the property at the time of the divorce.
- A divorced parent can claim a medical deduction on Schedule A (subject to the AGI exclusion) for any unreimbursed medical expenses paid for his/her child regardless of whether he/she is entitled to claim the child as a dependent. For purposes of the medical expense deduction, the child is considered to be the dependent of both parents.
- Only the parent who claims the student as a dependent can claim an education credit. This is true even if the divorce decree requires the other parent to pay the child's tuition directly to the college or university.
- Only the custodial parent can claim the credit for child and dependent care expenses. This is true even if the non-custodial parent claims the child as a dependent.
- Only the portion of legal fees that directly relates to providing tax advice or to efforts to obtain taxable alimony are deductible as a miscellaneous deduction on Schedule A (subject to the 2% of AGI limitations). Legal fees paid in an attempt to avoid alimony are not deductible.

Even though the classification of payments as alimony for federal income tax purposes is determined by the Internal Revenue Code and not the divorce agreement or a court order, the specific wording of the divorce agreement still remains important.

Several years ago, I had a problem defending an alimony deduction for a client because of poor wording in his divorce agreement. After calling on help from the Taxpayer Advocate Office, the problem was finally resolved in my client's favor.

The trouble with my client's payments arose from the wording in his "Dual Judgment of Divorce with Property Settlement Agreement." The judgment stated that, "The parties expressly waive past, present and future alimony against one another."

This statement was followed by, "The Husband shall pay to the Wife the sum of $650 per month, which should be applied to pay the monthly rent for {the ex-wife's apartment}. The balance should be used to defray the cost of insurance or other expenses related to this property."

My argument was that this $650 per month payment qualified as alimony under all the following required conditions:

- The payments were made directly to the former spouse in the form or cash or a cash equivalent.
- The payments were required by the written divorce agreement, and the agreement did not specifically state that the payments were not alimony.
- The taxpayer and his ex-spouse did not live in the same residence at any time during the year, nor did they file a joint income tax return.
- The payments were not for the support of a dependent child.

I further pointed out that the payments were not:

- Child support;
- Noncash property settlements;
- The spouse's part of community property income;
- Payments made to the ex-spouse for the use of the ex-spouse's property; or
- Payments for the upkeep of property owned by the taxpayer.

The problem could have been avoided if the agreement had stated, "The parties expressly waive past, present and future support payments against one another."

And it would have been even better had the agreement stated that "both spouses intend that this payment be treated as alimony" in reference to the $650 monthly payment.

Another issue, though assumed and implied, was that the agreement did not specifically state the payments would cease upon the death of the ex-wife. It's important that this condition be spelled out in the agreement. Instead, my client's agreement stated, "The Husband's obligation to pay this support shall terminate upon either the expiration of ten (10) years from the date of the Judgment of Divorce or upon Wife's remarriage or upon the Wife being the fee simple owner of this property or other property as a primary residence." The judgment should have included the phrase "or upon the death of Wife."

While the payments in this situation were made directly to the former spouse, payments to a third party on behalf of a former spouse for such things as insurance premiums, medical expenses, rent (as was the case with my client), mortgage payments (if the taxpayer making the payments is not the owner of the property), etc. are also considered to be alimony for federal income tax purposes if the payment is required under the terms of the divorce agreement. The payments are treated as received by the spouse and then paid to the third party.

Here again, it's also a good idea to have the agreement specifically state that "both spouses intend that these payments be treated as alimony."

When divvying up the marital assets during a divorce, the spouses generally consider only the dollar market value of the items being divided. However, when attempting to determine an equitable division of marital property, one must take into consideration the after-tax value of the assets.

Value each asset based not on its fair market value but on how much cash you would have in your hands after paying federal, state and local income taxes if the asset was disposed of on the day after the divorce is finalized. Marital assets could include, among other things: cash, personal property, pension accounts, stocks and bonds, collectibles, a personal residence and a vacation or rental property. The disposition of each item may be treated differently for tax purposes.

Cash (and any cash-equivalent such as a money market account) is worth what it's worth. The cost basis and the fair market value are the same. There is no tax consequence on the disposition of cash.

Personal use property (e.g., furniture, automobile, etc.) generally decreases in value over time. Because you can't deduct the loss on the sale of personal property, there's generally no tax consequence to the disposition of personal use property. However, any gain on the sale of personal use property is taxable.

The tax treatment of pension distributions depends on the type of account and the source of the contributions to the account. Distributions from a §401(k), §403(b) or §457 plan are generally fully taxable as ordinary income, since contributions are usually made "pre-tax." Qualified distributions from a Roth IRA are totally tax free. However, an IRA funded by individual contributions may have a "tax basis" depending on whether the contributions to the account were deductible or non-deductible. An IRA account, or an employer pension account partially funded by "after-tax" contributions, that has a "tax basis" is slightly more valuable than one from which distributions will be fully taxable.

hand, a vacation or rental property is taxed as a "capital asset," like stocks and bonds. In the case of a rental property, any depreciation claimed over the years must be "recaptured."

> "It was about as even a divorce settlement as you could hope for. Each lawyer got $50,000."
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> ~ Cartoon in *The Wall Street Journal*

Stocks and bonds are "capital assets" and are taxed upon disposition based on the basis and the holding period of the individual investment.

Gain on the sale of collectibles (artwork, rug, antique, precious metal, gem, stamp, coin or alcoholic beverage held more than one year) is taxed like stocks and bonds, or any other appreciated asset, although at possibly a higher tax rate.

An individual can exclude from taxable income up to $250,000 of gain on the sale of a personal residence, as long as he/she owned and lived in the residence for 24 months during the five-year period prior to its sale. So there may not be a tax consequence on the disposition of a personal residence. On the other

Example: A divorcing couple with assets valued at $550,000 decides on an equal split. Their cash balance of $50,000 will be split evenly. The wife will take full title to their personal residence valued at $250,000, which they owned and lived in for the past 30 years, and the husband will receive an investment portfolio of appreciated stocks worth $250,000. All of the stocks in the portfolio had been held for more than one year and the cost basis is $150,000. There is no mortgage or equity borrowing on the personal residence.

If the wife sells the personal residence, there will be no federal or state tax on the gain. However, if the husband liquidates the investment portfolio, he will pay 15% federal and 5% state income tax on the $100,000 taxable gain, a total of $20,000, because there is no basis adjustment for the transfer of assets in a divorce and the original $150,000 cost basis follows the investments to the husband. So the after-tax value of the portfolio is only $230,000. For the split of assets to be truly equal, the husband should get $35,000 of the cash and the wife only $15,000. Each spouse then walks away with $265,000 after taxes.

In the case of the sale of a personal residence under §121(d)(3)(B), "Solely for purposes of this section, an individual shall be treated as using property as such individual's principal residence during any period of ownership while such individual's spouse or former spouse is granted use of the property under a divorce or separation instrument [as defined in §71(b)(2)]."

So, if the title to the former marital home remains in the name of both divorcing spouses, but one spouse continues to live in the home as his or her personal residence, while the other moves out and may buy another home, both of them can exclude up to $250,000 of their share of the gain when the property is eventually sold, perhaps many years later, as long as one of them continues to use it as a personal residence. This must be specifically stated in the divorce agreement (another reason why the wording of the agreement is very important).

The U.S. Tax Code trumps the divorce agreement when it comes to who is able to claim a child as a dependent on the tax return. Regardless of what the divorce agreement says, federal tax law says that the custodial parent always gets the dependency deduction. It doesn't matter if the divorce agreement specifically states that the noncustodial parent gets the tax deduction, or that the parents will alternate the deduction each year. A local judge cannot overturn federal tax law.

The custodial parent is the parent with whom the child spent the most number of nights during the tax year. The determining factor is where the child "lays his head" each night. A child may spend all day at the father's home, but if he or she returns to the mother's home at night to sleep, that day is given to the mother. It's important that divorced parents keep a detailed "sleep log" for each child to be able to substantiate a claim of custodial parent.

The custodial parent can "release" the right to claim the dependency deduction for one or more child(ren) by providing the noncustodial parent with a signed Form 8332 to satisfy the divorce document. The dependency deduction can be released for (1) the current year only; (2) specific current and future years; or (3) all future years. The noncustodial parent claiming the exemption deduction must attach a copy of the signed Form 8332 to the tax return. A custodial parent can change his or her mind down the road and revoke the release of the dependency deduction previously given for future years.

If the divorce decree clearly states that the noncustodial parent is entitled to the deduction, but the custodial parent refuses to sign the Form 8332, the noncustodial parent must get the court to order the custodial parent to sign the form. When negotiating a divorce settlement that gives the dependency deduction to a noncustodial parent, it's wise to include specific terms that require the signing of Form 8332 and that outline any consequences for the custodial parent's refusal to do so (e.g., withholding of alimony payments or child support, or some other penalty).

> "I am a marvelous housekeeper. Every time I leave a man, I keep his house."
> ~ Zsa Zsa Gabor

A divorce agreement states that the noncustodial parent must pay 100% of the college expenses of his/her child. The noncustodial parent could not claim the benefits if he/she is not claiming the child as a dependent. However, the custodial spouse who claims the child as a dependent can claim the full $2,500 American Opportunity Tax Credit. If the college costs for the child total $50,000, and the noncustodial parent pays the full $50,000 to the college, the custodial parent will pocket $2,500. This could add up to $10,000 for four years of college (more if graduate school is included).

The agreement could state that the noncustodial parent must pay 100% of the college costs of the child less any related tax benefits received by the custodial parent. Or that subsequent alimony and/or child support payments are reduced by any related tax benefits received by the custodial parent.

Also consider alternative minimum tax and state and local taxes when reviewing divorce agreements.

The Bottom Line

It's important that clients who are considering a divorce consult a tax professional *before* the agreement and the property settlement is finalized. ■

About the Author

Robert D. Flach has been preparing 1040s for individuals in all walks of life since February of 1972. Since the summer of 2001, he has been writing the popular tax blog *The Wandering Tax Pro* (wanderingtaxpro.blogspot.com) and has also created and writes the websites *The Tax Professional* (thetaxprofessional.webs.com), *Find A Tax Professional* (findataxprofessional.com) and *A Tax Professional For Tax Reform* (taxprosfortaxreform-com.webs.com).